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IN THE

Supreme Court of the United States

CENDANT CORPORATION, TIME WARNER INC., RICHARD A. SMITH, DAVID COLBURN AND ERIC KELLER,

Petitioners,

v.

CALIFORNIA STATE TEACHERS RETIREMENT SYSTEM,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether a secondary actor may be primarily liable under Section 10(b) of the Securities Exchange Act of 1934 for engaging in a "scheme to defraud" with the issuer, notwithstanding this Court's decision in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), even where that secondary actor did not itself make or otherwise participate in making the challenged misstatements or omissions or engage in any act of "manipulation," and where the alleged misconduct of the secondary actor cannot satisfy all elements required for primary liability under Section 10(b).

LIST OF PARTIES AND STATEMENT PURSUANT TO RULE 29.6

L90, Inc., an appellee below, has not joined in this petition and is being served as a respondent.

Pursuant to Supreme Court Rule 29.6, petitioner Cendant Corporation[1] states that it does not have a corporate parent and there is no publicly held corporation that owns 10 percent or more of its outstanding shares of common stock.

Pursuant to Supreme Court Rule 29.6, petitioner Time Warner Inc. states that it does not have a corporate parent and there is no publicly held corporation that owns 10 percent or more of its outstanding shares of common stock.

1. Effective September 5, 2006, Cendant Corporation changed its name and is now known as Avis Budget Group, Inc.

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Appendix B — Opinion Of The United States District Court For The Central District Of California Dated March 7, 2003 ..... 32a

Petitioners Cendant Corporation ("Cendant"), Richard A. Smith ("Smith"), Time Warner Inc. ("Time Warner"), David Colburn ("Colburn") and Eric Keller ("Keller") (collectively, "Petitioners") respectfully request that a writ of *certiorari* issue to review the judgment of the United States Court of Appeals for the Ninth Circuit in this case.

OPINIONS BELOW

The order of the district court granting Petitioners' motions to dismiss the first amended consolidated complaint with prejudice is reported at 252 F. Supp. 2d 1018 (C.D. Cal. 2003) and is reprinted in the Appendix ("Pet. App.") at 32a-90a. The decision of the Court of Appeals for the Ninth Circuit (Gould, J., joined by Beezer and Nelson, JJ.) affirming the district court, but remanding for further proceedings, is published at 452 F.3d 1040 (9th Cir. 2006) and reprinted at Pet. App. 1a-31a.

STATEMENT OF JURISDICTION

The court of appeals filed and entered its opinion and judgment on June 30, 2006. On September 21, 2006, this Court granted an extension of time through November 13, 2006 to file this petition. This Court has jurisdiction under 28 U.S.C. § 1254(1).

STATUTORY AND REGULATORY PROVISIONS INVOLVED

The relevant statutory and regulatory provisions are Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (the "Exchange Act"), and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5 (2004).

Section 10(b) of the Exchange Act provides in relevant part:

> **§ 78j. Manipulative and deceptive devices**
>
> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange –
>
> * * *

> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act), any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest for the protection of investors.

15 U.S.C. § 78j(b).

Rule 10b-5 promulgated thereunder provides:

> **§ 2401.10b-5 Employment of manipulative and deceptive devices.**
>
> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5.

STATEMENT OF THE CASE

1. Factual Background and Filing of Complaint

This securities class action was commenced shortly after a December 21, 2001 public announcement by Homestore.com, Inc. ("Homestore") stating that recently discovered accounting

errors had caused it to recognize revenue improperly. After an internal investigation, Homestore restated its financial statements for 2000 and the first three quarters of 2001. According to the First Amended Consolidated Complaint ("FACC") of plaintiff California State Teachers' Retirement System ("Plaintiff"), the restatement reduced Homestore's previously-reported aggregate revenue for that period by approximately $190 million.

This action initially was brought against only Homestore and three of its senior executives. In the FACC, Plaintiff added Exchange Act claims against virtually every company (and a number of individuals), including Petitioners Cendant and Time Warner, as well as L90, Inc. ("L90"), that allegedly were parties to one or more of the business transactions which Homestore accounted for improperly on its financial statements. Petitioner Smith served as Chairman and Chief Executive Officer of Cendant's Real Estate Division and was alleged to have been involved in the disputed transactions involving Cendant. Petitioners Colburn and Keller served as managers in the business affairs unit of Time Warner and were alleged to have been involved in the disputed transactions involving Time Warner.

None of these additional 19 defendants (collectively, the "Outside Defendants") was alleged to have made (or participated in the making of) any of Homestore's purportedly false and misleading statements (or omissions) or Homestore's accounting decisions. Instead, the theory of the FACC as to the Outside Defendants was that, by entering into business transactions with Homestore with knowledge that *Homestore* would account for such transactions improperly on *Homestore's* financial statements, the Outside Defendants engaged in a Rule 10b-5 "scheme to defraud" that assisted Homestore's fraud – *i.e.*, Homestore's allegedly improper recognition of revenue from those transactions on its published financial statements. Plaintiff alleged that, without this supposed "participation" of the Outside Defendants, "Homestore could not [have] undertake[n] this financial fraud." *See* FACC at 2.

As summarized by the Ninth Circuit, the nature of the alleged business transactions involving Petitioners and L90[2] was as follows:

> Plaintiff alleges Homestore entered into fraudulent transactions with [Time Warner and L90] in which Homestore purchased revenue for itself and then recorded that revenue in violation of SEC accounting rules. In the alleged "triangular transactions," Homestore entered into sham transactions with "Third Party Vendors" who then returned the money to Homestore through contracts with [Time Warner] or L90. Plaintiff alleges Homestore overpaid for an asset owned by Cendant in return for Cendant's agreement that it would funnel some of the money back to Homestore through a related business entity. The complaint further alleged that the recording of gross revenue from these transactions [by Homestore] contravened SEC rules regarding barter transactions or the buying of revenue, and that the triangular transactions were often done without the full knowledge of Homestore's auditor.
>
> (Pet. App. 2a-3a).

2. Proceedings in the District Court

In January 2003, Petitioners and the other Outside Defendants moved to dismiss the FACC, arguing that the FACC was defective as a matter of law in light of *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994).

The District Court agreed. In an Opinion and Order dated March 7, 2003, the District Judge held that the Section 10(b) claims in the FACC should be dismissed as against the Outside Defendants (the "Dismissal Order"). In reaching this decision,

2. In the Ninth Circuit, Plaintiff abandoned its appeal of the District Court's dismissal (also pursuant to *Central Bank*) of the FACC as against the other thirteen Outside Defendants. Accordingly, those transactions are not discussed herein.

the District Judge found that the alleged conduct of the Outside Defendants – *i.e.*, entering into transactions with Homestore that allegedly facilitated Homestore's ability to improperly recognize revenue – "appears to be exactly the role of aiders and abettors prior to *Central Bank*, and is exactly the role that *Central Bank* exempted from liability." (Pet. App. 81a).

The District Court observed that the FACC failed to allege that any of the Outside Defendants made any of the purportedly false or misleading statements by Homestore or "played any 'significant role' in the drafting or editing of such statements." (Pet. App. 79a). The District Court declined Plaintiff's invitation to excuse this legal defect simply because the FACC characterized the Outside Defendants' role in entering into business transactions with Homestore as "participation" in a "scheme to defraud." Rather, the District Court held that such a "scheme" theory would improperly impose primary liability on the Outside Defendants even though Plaintiff did not rely on their purported conduct. As the District Court explained:

> In the present case, plaintiff suffered damage through its reliance on false or misleading statements, not from the 'scheme' itself. Thus, the scheme is one step removed from the injured party. The scheme was not complete until the statement was made. Essentially what plaintiff alleges is a scheme to make a deceptive statement or material omission. Yet the principal "wrong" under the rule is the statement, not the scheme. Therefore, it is appropriate to require defendants in this case to be connected in some material way to the drafting of the statements made to the investing public. Here, this means the SEC filings, the press releases, the oral statements of Homestore, and the supporting statements of its auditor . . . . Because plaintiff did not (and cannot) sufficiently allege that any of the [Outside Defendants] substantially contributed to those statements, it cannot state a claim against those

> defendants for damages resulting from reliance on statements or material omissions.

(Pet. App. 80a).

Accordingly, applying *Central Bank*, the District Court held that the Outside Defendants could not be held liable for any material misstatement or omission by Homestore (or any of its officers) no matter how much "[they] assisted or participated in transactions that led to th[ose] statement[s] or omission[s]." (Pet. App. 77a). The District Court also observed that a contrary holding "would broaden the scope of the securities acts so as to haul into court anyone doing business with a publicly traded company," a result the District Court concluded would be patently improper in light of *Central Bank* and "absent direction from Congress," which in 1995 had specifically "declined to create an express private right of action for aiding and abetting securities fraud" in the wake of *Central Bank*. (Pet. App. 74a).

3. The Decision Below

Plaintiff appealed to the United States Court of Appeals for the Ninth Circuit. On June 30, 2006, the Ninth Circuit issued its opinion, affirming the District Court's dismissal of the FACC, but remanding to the District Court "so that Plaintiff may seek leave . . . to amend the complaint if that can be done consistent with this opinion." (Pet. App. 31a). In its decision, the Ninth Circuit declined to reject as a matter of law – as foreclosed by *Central Bank* – the "scheme to defraud" theory of liability advanced by Plaintiff. Rather, the Ninth Circuit articulated a novel legal standard under which "scheme" allegations may adequately state a Section 10(b) claim against secondary actors consistent with *Central Bank*.

The Ninth Circuit focused only on the "deceptive" prong of Section 10(b) because it agreed that the alleged conduct of the Outside Defendants could not be considered "manipulative" as that term of art is used in the securities context. (*See* Pet. App. 13a n.2 (citing *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977)). It also focused only on alleged "misstatements," finding that there could be no "actionable omissions" because

"[t]here are no allegations that any Defendant was subject to a duty to disclose in the context of these transactions." (Pet. App. 13a n.2).

Nevertheless, the Ninth Circuit concluded that a secondary actor may be liable for "deceptive" conduct under Section 10(b) by engaging in a "scheme to defraud" with the issuer when the secondary actor's conduct had "the principal purpose and effect of creating a false appearance of fact in the furtherance of a scheme to defraud" (Pet. App. 16a) (the "Purpose and Effects Test"), even where the secondary actor does not make (or otherwise participate in the making of) any alleged misstatements or omissions. According to the Ninth Circuit, if its newly articulated Purpose and Effects Test is satisfied, then the secondary actor has itself engaged in "deceptive" conduct within the meaning of Section 10(b) and, thus, can be held primarily liable consistent with this Court's decision in *Central Bank*. In so ruling, the Ninth Circuit rejected the argument – accepted only a few months earlier by the Eighth Circuit in *In re: Charter Communications, Inc. Securities Litigation*, 443 F.3d 987 (2006), *petition for cert. filed*, 75 U.S.L.W. 3034 (U.S. July 7, 2006) (No. 06-43) – that the only conduct which can be "deceptive" within the meaning of Section 10(b) (as construed by this Court) is the making of a material misstatement or an omission (where one is under a duty to disclose).

The Ninth Circuit next addressed whether an additional element of a Section 10(b) claim – that the actionable conduct be "in connection with" the purchase or sale of a security – could be satisfied as against a non-speaking secondary actor in a "scheme to defraud" case such as this. Without focusing (as we submit it should have) on the specific alleged conduct by the secondary actor in furtherance of the so-called "scheme," the Ninth Circuit, citing to no legal precedent, summarily concluded that a "scheme" itself, viewed as a whole, could be viewed as having "coincided" with the sale of securities, such that the "in connection with" element would be satisfied. More specifically, the Ninth Circuit explained:

> Similarly, a scheme to misrepresent the publicly reported revenue of a company may coincide with the purchase or sale of securities because the scheme will not be complete until the fraudulent information is introduced into the securities market. That every participant in the scheme did not release the information to the public does not diminish the causal connection between all defendants in the scheme and the securities market. . . . If multiple participants used or employed a deceptive device in furtherance of a scheme to misrepresent the reported revenues of a company, then all participants may be viewed as having acted in connection with the purchase or sale of securities.

(Pet. App. 21a).

Finally, the Ninth Circuit addressed whether the critical element of "reliance" could be satisfied as against secondary actors in a "scheme to defraud" case. The inability of plaintiffs to demonstrate reliance on a secondary actor's conduct was one of the primary reasons this Court had rejected "aiding and abetting" liability in *Central Bank*. *See Central Bank*, 511 U.S. at 190-91. Accordingly, Petitioners argued to the Ninth Circuit that, just as with "aiding and abetting" liability, holding secondary actors liable under a "scheme to defraud" theory in a statements case, where such actors did not make any of the challenged statements, would improperly dispense with the element of reliance by imposing liability on secondary actors where plaintiffs relied *only* on statements made by others, and not on any words or conduct of the secondary actor in furtherance of the alleged "scheme."

Rather than address this argument directly in its decision, the Ninth Circuit implicitly rejected it and instead articulated yet another novel legal theory under which a plaintiff's "reliance" on a silent secondary actor's conduct in "scheme" cases would simply be presumed:

> We may presume, absent persuasive conflicting evidence, that purchasers relied on misstatements produced by defendant as part of a scheme to defraud, even if the defendant did not publish or release the misrepresentations directly to the securities market .... [A] plaintiff may be presumed to have relied on this scheme to defraud if a misrepresentation, which necessarily resulted from the scheme and the defendant's conduct therein, was disseminated into an efficient market and was reflected in the market price.

(Pet. App. 23a).

Having thus articulated three entirely new legal standards to support potential liability in "scheme" cases – the "Purpose and Effects" test, that the scheme as a whole need only coincide with the purchase or sale of securities, and that reliance upon a secondary actor's conduct may simply be presumed – the Ninth Circuit concluded that the conduct of Petitioners, as currently alleged in the FACC, failed to satisfy the Purpose and Effects Test and, thus, that the FACC was properly dismissed. In order to allow Plaintiff the opportunity to "take advantage of the reasoning in [its] opinion," however, the Ninth Circuit remanded the case to the District Court where Plaintiff "may seek leave . . . to amend the complaint" again in a manner which might satisfy the newly articulated standards for "scheme" liability against secondary actors.

SUMMARY OF ARGUMENT

The decision below conflicts squarely and directly with the Eighth Circuit's recent decision in *Charter*, which correctly applied *Central Bank* to hold that "any defendant who does not make or affirmatively cause to be made a fraudulent misstatement or omission, or who does not directly engage in manipulative securities trading practices, is at most guilty of aiding and abetting and cannot be held liable under Section 10(b) or any subpart of Rule 10b-5." 435 F.3d at 992. It also conflicts with the holdings of every other circuit that, in the wake of *Central Bank*, has considered the issue of whether secondary-

actor defendants who were not alleged to have made any of the allegedly false statements (or omissions) themselves can be liable under Section 10(b). *See, e.g., Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215, 1226 (10th Cir. 1996); *Shapiro v. Cantor*, 123 F.3d 717, 720 (2d Cir. 1997); *Ziemba v. Cascade Int'l, Inc.*, 256 F.3d 1194, 1205 (11th Cir. 2001).

The Ninth Circuit's ruling is contrary to *Central Bank* and other precedent of this Court because it permits liability against secondary actors for conduct that, prior to *Central Bank*'s rejection of aiding and abetting liability, was alleged to be classic "aiding and abetting" conduct. It also permits such liability against secondary actors under novel and unprecedented legal theories: The court below allows plaintiffs the benefit of a "presumption of reliance" upon the secondary actor's conduct even where a plaintiff relied only on the conduct (*i.e.*, statements) of someone other than the secondary actor, and it sets forth the legal fiction that the secondary actor's conduct can be viewed as having "coincided with" or occurred "in connection with" the purchase or sale of a security because the "scheme to defraud" as a whole (and the conduct of all participants in the scheme) coincides with the purchase or sale of securities once another participant in the scheme introduces fraudulent information into the marketplace.

A writ of certiorari to review the decision below is warranted now. The question presented is a discrete and important issue of federal statutory law that has been the subject of extremely thorough, albeit conflicting, analyses and holdings by the circuit courts and district courts throughout the country. In an area of law that this Court has stated "demands certainty and predictability," *Central Bank*, 511 U.S. at 188 (citation omitted), the legal standard of liability adopted by the court below threatens a large number of companies with the costs of defending potentially expensive and vexatious securities litigation in the Ninth Circuit simply because they engaged in business transactions with issuers who allegedly subsequently accounted for the transactions fraudulently. This case is a

paradigmatic example of that threat. Despite prevailing at both the District Court and the Ninth Circuit, if the District Court were to erroneously rule against Petitioners on remand, Petitioners would have no appeal as of right as to that decision until after costly discovery and a trial. Because many non-speaking defendants in the position of Petitioners will settle rather than face such costs and risks, this Court's immediate review is necessary to prevent the continuation of frivolous litigation and unmerited settlements.

REASONS FOR GRANTING THE PETITION

I. The Decision Below Directly Conflicts with Four Other Circuit Courts On an Important and Recurring Issue of Federal Securities Law

Pursuant to the novel legal tests articulated in the decision below, the Ninth Circuit concluded that a secondary actor may be primarily liable for securities fraud when that secondary actor engaged in "conduct that had the principal purpose and effect of creating a false appearance of fact in furtherance of the scheme [to defraud with the issuer.]" (Pet. App. 16a). In so holding, the Ninth Circuit expanded on the definition of "deception" under Section 10(b) beyond false statements or omissions. The decision below squarely conflicts with the Eighth Circuit's recent decision in *Charter*, 443 F.3d at 992 ("[a] device or contrivance is not "deceptive," within the meaning of § 10(b), absent some misstatement or a failure to disclose by one who has a duty to disclose"), as well as every other circuit that has considered this issue in the wake of *Central Bank*. *See, e.g.*, *Anixter*, 77 F.3d at 1226 (10th Cir. 1996) ("Reading the language of 10(b) and 10b-5 through the lens of Central Bank of Denver, we conclude that in order for [secondary actors] to "use or employ" a "deception" actionable under the antifraud law, they must themselves make a false or misleading statement (or omission) that they know or should know will reach potential investors."); *Shapiro v. Cantor*, 123 F.3d 717, 720 (2d Cir. 1997) (same); *Ziemba v. Cascade Int'l, Inc.*, 256 F.3d 1194, 1205 (11th Cir. 2001) (same).

In *Charter*, the plaintiffs brought a securities fraud class action against a publicly-traded cable television provider (the "Issuer"), in which they challenged certain of the Issuer's financial statements and press releases as materially misleading. *Id.* at 990. The plaintiffs also named as defendants, among others, two of the Issuer's equipment vendors (the "Vendors"), alleging that the vendors could also be liable as primary violators for engaging in a "scheme to defraud" with the Issuer, because the Vendors allegedly entered into "sham transactions" with the Issuer "knowing" that the Issuer intended to later account for them improperly on the Issuer's financial statements. *Id.* at 989-90. The alleged sham transactions involved the Issuer paying additional money to the Vendors to be returned to the Issuer in the form of advertising fees. *Id.* at 990.

Thus, in *Charter*, as here, plaintiffs sought to hold secondary actors liable for a "scheme to defraud" under Section 10(b) based on their having entered into transactions with the issuer defendant, which the issuer then purportedly accounted for fraudulently on its financial statements. *Id.* at 991. As is the case here, the secondary actor defendants in *Charter* were not alleged to have made any publicly disseminated misstatements or to have played any role in preparing or disseminating the Issuer's allegedly fraudulent financial statements and press releases on which plaintiffs relied.

Yet contrary to the decision below, the Eighth Circuit in *Charter*, relying on *Central Bank*, affirmed dismissal of plaintiffs' complaint against the Vendors and flatly rejected plaintiffs' attempt to utilize a Rule 10b5 "scheme to defraud" theory of liability to circumvent *Central Bank*. *See id.* at 992. More specifically, the Eighth Circuit reasoned that "any defendant who does not make or affirmatively cause to be made a fraudulent misstatement or omission, or who does not directly engage in manipulative securities trading practices, is at most guilty of aiding and abetting and cannot be held liable [for a "scheme to defraud"] under Sec. 10(b) or any subpart of Rule 10b-5." *Id.* Thus, according to the Eighth Circuit, the district

court properly dismissed the claims against the secondary actors "as nothing more than claims[ ] barred by *Central Bank*."[3] *Id.*

The Eighth Circuit's decision in *Charter* followed that of numerous other courts of appeals that, in the wake of *Central Bank* and standing in direct conflict with the decision below, routinely dismissed securities fraud claims against secondary-actor defendants who were not alleged to have committed a primary violation of Section 10(b) by themselves making any of the allegedly false statements (or omissions). *See, e.g.*, *Shapiro v. Cantor*, 123 F.3d 717, 720 (2d Cir. 1997) ("If *Central Bank* is to have any real meaning, a defendant must actually make a false or misleading statement . . . [a]nything short of such conduct is merely aiding and abetting. . . ."); *Anixter*, 77 F.3d 1215, 1226 (10th Cir. 1996) (same); *Ziemba v. Cascade Int'l, Inc.*, 256 F.3d 1194, 1205 (11th Cir. 2001) (same).[4]

3. The Second Circuit recently reached a similar result as the Eighth Circuit in a summary order. *See Filler v. Hanvit Bank*, Nos. 04-6295-CV, 04-6719-CV, 156 F. App'x 413, 2005 U.S. App. LEXIS 26443 (2d Cir. Dec. 2, 2005). In *Filler*, the plaintiffs brought a Section 10(b) claim against three banks alleging that the banks engaged in "sham transactions" with an issuer that enabled the issuer to inflate its earnings and revenues. 156 F. App'x at 414, 2005 U.S. App. LEXIS 26433, at * 3. The banks were even alleged to have issued false loan confirmations to the issuer's auditor. *Id.* The Second Circuit, relying on *Central Bank* and several Second Circuit decisions in the wake of *Central Bank*, affirmed the dismissal of plaintiffs' claims, holding that "'a defendant must actually make a false or misleading statement in order to be held liable under Section 10(b)'" and that the misrepresentation must be attributed to the defendant at the time of public dissemination. *Id.* at 415, 2005 U.S. App. LEXIS, at *6 (quoting *Shapiro v. Cantor*, 123 F.3d 717, 720 (2d Cir. 1997)). According to the Second Circuit, "'[a]nything short of such conduct is merely aiding and abetting, and no matter how substantial that aid may be, it is not enough to trigger liability under Section 10(b).'" *Id.* (quoting *Shapiro*, 123 F.3d at 720).

4. These decisions are from Circuits which follow what is commonly-referred to as the "bright-line" rule, under which liability under Section 10(b) can be imposed on those who actually make a false

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See generally Brian E. Pastuszenski, Christopher F. Robertson & Jason D. Frank, *Central Bank is Alive and Well: Defense Strategies for Defeating "Scheme to Defraud" Allegations in Private Securities Litigation*, American Law Institute, at 441 (May 2003) ("*ALI Commentary*").

This Court should grant review to resolve the direct conflict between the decision below and that of the Eighth Circuit and other circuits in post-*Central Bank* decisions.

II. The Decision Below Is Incorrect Under the Standard for Section 10(b) Liability Articulated in Settled Decisions of this Court

A. The Decision Below Cannot Be Reconciled With This Court's Precedents Governing Primary Liability Under Section 10(b).

The decision below undermines core securities law precedents of this Court because it does not limit section 10(b) liability to the making of a misstatement (or omission) or engaging in an act of "manipulation." It is well settled under longstanding decisions of this Court that Section 10(b) only prohibits conduct that is "manipulative" or "deceptive" within the meaning of the statute. *See Hochfelder*, 425 U.S. at 213-14. "Manipulative" conduct has been defined by this Court as "virtually a term of art when used in connection with securities markets . . . [which] refers generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity." *Santa Fe*, 430 U.S. at 476. This Court has defined "deceptive" conduct

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statement or, at the very least, to whom the false statement is attributed at the time that it is made. The Ninth Circuit, in the wake of *Central Bank*, adopted a more lenient standard than the bright-line rule, under which Section 10(b) liability for a "misstatement" may extend to those who either (i) make such a statement, *or* (ii) directly and substantially participate in the making (i.e., drafting or editing) of a false statement by another. *See, e.g., In re Software Toolworks Inc. Sec. Litig.*, 50 F.3d 615, 628-29 & n.3 (9th Cir. 1995).

to include only the common law categories of a misrepresentation or an omission if there is a duty to disclose. *See Chiarella v. United States*, 445 U.S. 222, 236 (1980).

Moreover, the Court has repeatedly recognized that subsections (a) and (c) of Rule 10b-5 – where the "scheme" to defraud language relied upon by the Ninth Circuit is found – cannot create liability for conduct that is not prohibited under Section 10(b), the Rule's enabling statute. *See United States v. O'Hagan*, 521 U.S. 642, 651 (1997) ("Liability under Rule 10b-5, our precedent indicates, does not extend beyond conduct encompassed by [Section] 10(b)'s prohibition."); *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 472-74 (1977) (rejecting an attempt to state a claim under clauses (a) and (c) of Rule 10(b) because "the language of the statute must control the interpretation of the Rule"); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 213-14 (1976) (Rule 10b-5's "scope cannot exceed the power granted the [SEC] by Congress under § 10(b)").

Accordingly, the "only" conduct which violates Section 10(b) – and thus can be a basis for primary liability under section 10(b) or Rule 10b-5 – is the making of a material misstatement (or omission) or the commission of a manipulative act. This Court unambiguously reaffirmed this principle in *Central Bank*:

> As in earlier cases considering conduct prohibited by § 10(b), we again conclude that the statute prohibits *only* the making of a material misstatement (or omission) or the commission of a manipulative act.

511 U.S. at 177 (emphasis added) (citing *Santa Fe*, 430 U.S. at 473 (1977); *Hochfelder*, 425 U.S. at 214.[5] The holding and

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5. Further underscoring this Court's long-held view is the fact that no decision exists in which this Court has found Section 10(b) liability to exist absent an act of "manipulation," or a false statement or omission. *See Santa Fe Indus.*, 430 U.S. at 474 (merger transaction was not "deceptive" for purposes of Section 10(b) liability where complaint failed to allege a material misrepresentation or failure to disclose). Insider trading cases are no exception, since Section 10(b) liability in (Cont'd)

import of this well-established precedent is clear: Secondary actors can *only* be liable for securities fraud if they *themselves* "employ[ ] a manipulative device or make[ ] a material misstatement (or omission)" and "*all*" other elements for primary liability under Section 10(b) are satisfied. *Id.* at 191 (emphasis in the original).

According to the decision below, however, a secondary actor may be primarily liable for securities fraud despite not having made any of the challenged misstatements or omissions if that secondary actor engaged in "conduct that had the principal purpose and effect of creating a false appearance of fact in furtherance of the scheme [to defraud.]" (Pet. App. At 16a). But this same "scheme to defraud" theory of liability for secondary actors was advanced and rejected by this Court in *Central Bank.* Seizing on the "scheme" language of Rule 10b-5, as plaintiffs do here, the National Association of Securities and Commercial Law Attorneys, as *amicus curiae* in support of respondents in *Central Bank*, argued that "a scheme to defraud typically involves multiple parties who conspire with, or aid and abet, one another in order to perpetrate the fraudulent scheme" and thus "[a]ll members of such a scheme are responsible [under Rule 10b-5]." *See* Brief for Amicus Curiae National Association of Securities and Commercial Law Attorneys in Support of Respondents at 3-4, *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994). This Court did not accept this argument, holding instead that section 10(b) prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act. *See Central Bank*, 511 U.S. at 177. This holding was consistent with long-settled securities precedent of this Court:

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those situations are based on one or more "omissions" by a trader who fails to disclose information in circumstances where there is a duty to speak. *See United States v. O'Hagan*, 521 U.S. 642, 651 (1997) (insider trading violates Section 10(b) and Rules 10b-5(a) and (c) because it involves a trader's failure to disclose — an "omission" — in circumstances where the trader has a duty to speak).

Even in cases relying on Rule 10b-5(a) (where the "scheme . . . to defraud" language is found), this Court has declined to allow Section 10(b) liability for an omission by someone who neither speaks nor has a duty to disclose as a fiduciary. *See Chiarella v. United States*, 445 U.S. 222, 230, 235 (1980); *Dirks v. SEC*, 463 U.S. 646, 665-667 (1983).

The Ninth Circuit attempts to reconcile its "scheme to defraud" holding with this Court's precedent by relying on *SEC v. Zandford*, 535 U.S. 813 (2002). According to the Ninth Circuit, *Zandford* "held that a non-speaking actor who engages in a 'scheme to defraud' has used or employed a deceptive device within the meaning of Section 10(b)." (Pet. App. 14a). But this reliance on *Zandford* is unavailing and incorrect. *Zandford* did not alter this Court's long-held view, as reaffirmed in *Central Bank*, that the only conduct prohibited by Section 10(b) is the making of a misstatement (or omission) or the commission of a manipulative act. Rather, *Zandford* was a classic Section 10(b) "omission" case involving a fiduciary (who had a duty to disclose) who defrauded his client by engaging in the purchase and sale of securities without disclosing to the client certain material information.[6] *See Zandford*, 535 U.S. at 820-25 & n.4 ("any distinction between omissions and misrepresentations is illusory *in the context of a broker who has a fiduciary duty to her clients*") (emphasis added). The issue in *Zandford* was not whether the fiduciary's omission was fraudulent within the meaning of Section 10(b); rather, the fraudulent nature of the conduct was undisputed because the broker owed a fiduciary duty, and the only issue decided by this Court was whether that fiduciary's omission was "in connection with" the sale of a security.

6. More specifically, in *Zandford*, the defendant broker sold his client's securities and stole the proceeds. See *Zandford*, 535 U.S. at 820-25. The reason that this conduct violated section 10(b) was that the broker breached his duty to disclose to his client that the reason he liquidated her stocks was to misappropriate the proceeds for his own use. *See id.* Without the duty to disclose and resultant omission, the broker would not have engaged in conduct violating the statute.

Nothing in *Zandford* thus supports the Ninth Circuit's conclusion that engaging in a Rule 10b-5 "scheme to defraud" can be an independent ground for liability against a secondary actor where that actor did not itself violate Section 10(b) by making a misleading statement or omission in the face of a duty to disclose.

B. The Decision Below Erroneously Permits a Species of "Aiding and Abetting" Liability Under A Different Name, In Direct Contravention of Central Bank.

If allowed to stand, the decision below will reopen liability that *Central Bank* foreclosed. *See, e.g., ALI Commentary*, at 443 (post-*Central Bank*, the plaintiffs' securities bar began arguing that "scheme to defraud" could properly be read broadly enough to reach secondary actors not alleged to have made any statement relied upon by plaintiffs, "notwithstanding that such a broad reading . . . would appear to overrule the Supreme Court's prohibition on aiding and abetting liability").

The Ninth Circuit's approach contradicts *Central Bank* because it would permit liability for securities fraud against secondary actors who have not themselves engaged in conduct that violates Section 10(b). As recent accounts in the securities industry press recognize, "[i]f the courts, such as the Ninth Circuit in the Homestore appeal, accept 'scheme to defraud' liability . . . the impact of *Central Bank* will be largely vitiated . . . and the old aiding and abetting moniker will no longer be needed to bring lawyers, accountants, and banks (and possibly even business partners) back into the securities class action arena." Tracy A. Nichols & Stephen P. Warren, *Aiding and Abetting Liability Under Section 10(B)*, S&P's Rev. of Sec. & Commodities Reg., May 4, 2005; *see also* Peter M. Saparoff & Breton Leone-Quick, *Secondary Actor Liability: The Next Major Securities Litigation Issue to be (Re) Considered by the Supreme Court?*, American Law Institute, at 883 (April 2005) ("[A]s a result of . . . rulings

[implementing and adhering to *Central Bank*], plaintiffs are now alleging claims based on non-representational conduct pursuant to either Rules 10b-5(a) and (c), or a fraudulent 'scheme' theory under Section 10(b) itself."); Matthew L. Mustokoff, *"Scheme" Liability Under Rule 10B-5: the New Battleground in Securities Fraud Litigation*, Federal Lawyer, at 20 (June 2006) ("[N]owadays, increasingly more plaintiffs, in an attempt to sidestep the ruling handed down in *Central Bank*, are relying on Rule10b-5(a) and (c).").

Indeed, the conduct of Petitioners that Plaintiff challenges here under a "scheme to defraud" theory of liability is the same sort of conduct that was challenged as "aiding and abetting" prior to *Central Bank*. *See, e.g., K&S P'ship v. Cont'l Bank, N.A.*, 952 F.2d 971, 976-77, 979-80 (8th Cir. 1991) (participation in business transactions challenged as "substantial assistance" in furtherance of primary violation); *Feldman v. Pioneer Petroleum, Inc.*, 813 F.2d 296, 301 (10th Cir. 1987) ("Plaintiffs also alleged that Fidelity Bank, N.A. and its president . . . aided and abetted in a conspiracy to promote the scheme by engaging in a fraudulent and deceptive transaction . . . ."); *see also Landy v. FDIC*, 486 F.2d 139, 163 (3d Cir. 1973) (addressing whether the "substantial assistance" component of aiding and abetting was satisfied where the secondary actor engaged in "a business transaction . . . which foreseeably permits one of the parties to it . . . to independently engage in illegal action"). In the words of the District Court below, Petitioners were alleged to have played "exactly the role [in Homestore's fraud] that *Central Bank* exempted from liability." (Pet. App. 81a).

The Ninth Circuit's legally defective "scheme to defraud" theory should not be permitted to stand simply because it may be used to reach (and/or deter) allegedly "bad" conduct by secondary actors that would otherwise not be subject to a private right of action. Under the federal securities laws, Section 10(b) is but one provision of a broad remedial

scheme. For example, in 1995, Congress amended the Exchange Act – in direct response to *Central Bank* – to authorize the SEC to bring enforcement actions for aiding and abetting violations of Section 10(b). *See* 15 U.S.C. § 78t(e) (2006). But at the same time, Congress specifically elected to leave intact *Central Bank*'s bar on such claims by private litigants. *See, e.g.*, Senate Report (Banking, Housing, and Urban Affairs Committee), S. Rep. No. 104-98, at 19 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 698 ("The Committee considered testimony endorsing the result in *Central Bank* and testimony seeking to overturn this decision. The Committee believes that amending the [Exchange] Act to provide explicitly for private aiding and abetting liability actions under Section 10(b) would be contrary to S. 240's goal of reducing meritless securities litigation. The Committee does, however, grant the SEC express authority to bring actions seeking injunctive relief or money damages against persons who, knowingly aid and abet primary violators of the securities law."); *see also id.* at 49, 1995 U.S.C.C.A.N. at 727 (considering SEC Chairman's testimony that private "aiding and abetting" liability should be restored so that individuals who "act behind the scenes and do not themselves make statements" may be liable under Section 10(b)).

Thus, in addition to creating an impermissible end-run around this Court's decision in *Central Bank*, the decision below improperly disregards the express intent of Congress by effectively reviving a species of "aiding and abetting" liability even though Congress specifically decided it should *not* exist. *See generally Till v. SCS Credit Corp.*, 541 U.S. 465, 480 n.19 (2004) (declining to adopt an interpretation of the Bankruptcy Code that "Congress considered but rejected"); *Fiedler v. Clark*, 714 F.2d 77, 79 (9th Cir. 1983) (declining to recognize right of action that "Congress considered and explicitly rejected"); *see also In re Sargent Walnut Ranches, Inc.*, 219 B.R. 880, 884 (E.D. Cal. 1998)

("It is one thing to construe a statute liberally. It is another to legislate from the bench.").

C. The Ninth Circuit's Approach Erroneously Dispenses With the Critical Element of Reliance.

Central Bank's discussion of reliance in rejecting aiding and abetting liability applies with equal force to – and demonstrates a fundamental defect of – the "scheme to defraud" theory of liability accepted by the Ninth Circuit in the decision below. In a "statements" case such as this, to sanction liability against a secondary actor that did not make *any* of the challenged misstatements or omissions, or participate in the making of such statements, would create liability for the secondary actor without any showing that the plaintiff relied upon such actor's conduct – precisely the result this Court rejected in *Central Bank*. *See Central Bank*, 511 U.S. at 181.

In *Central Bank*, this Court made clear that a secondary actor can be liable for securities fraud only if "*all*" of the elements under Section 10(b) are satisfied in respect of the secondary actor. 511 U.S. at 191. One such fundamental element is reliance, a point emphasized in *Central Bank*. *Id.* at 180 ("A plaintiff must show reliance on *the defendant's* misstatement or omission to recover under 10b-5.") (emphasis added); *see also Dura Pharms., Inc. v. Broudo*, 544 U.S. 336, 341-42 (2005) (reliance is one of the "basic elements" of a Section 10(b) claim).

The Ninth Circuit below, applying circular reasoning, held that reliance could be satisfied in respect of a non-speaking secondary actor in a "scheme to defraud" case because a plaintiff "may be *presumed* to have relied on th[e] scheme to defraud if a misrepresentation, which necessarily resulted from the scheme and the defendant's conduct therein, was disseminated into an efficient market and was reflected in the market price." (Pet. App. 23a) (emphasis added).

But this newly adopted presumption of "reliance" cannot be squared with *Central Bank*. In fact, the inability of plaintiffs to establish reliance in respect of secondary actors was one of the primary reasons this Court rejected aiding and abetting liability in *Central Bank*. *See id.* at 180. Under an aiding and abetting theory of liability, this Court reasoned, a defendant could be found liable without any showing by plaintiff that he relied upon any statement or act *by the defendant* in making his investment decision. *See id.* As this Court explained, such a result would be patently improper:

> Our reasoning is confirmed by the fact that respondents' arguments would impose 10b-5 aiding and abetting liability when at least one element *critical* for recovery under 10b-5 is absent: reliance. A plaintiff must show reliance on *the defendant's* misstatement or omission to recover under 10b-5. *Were we to allow the aiding and abetting action proposed in this case, the defendant could be liable without any showing that the plaintiff relied upon the aider and abettor's statements or actions* . . . . Allowing plaintiffs to circumvent the reliance requirement would disregard the careful limits on 10b-5 recovery mandated by our earlier cases.

See id. (citations omitted; emphasis added).

In adopting a "presumption" of reliance, the court below failed even to address this Court's discussion of reliance in *Central Bank*, much less attempt to reconcile its "presumption" with *Central Bank*. Instead, the Ninth Circuit relied on two district court decisions – *In re ZZZZ Best Securities Litigation*, 864 F. Supp. 960, 973 (C.D. Cal. 1994), and *In re Parmalat Securities Litigation*, 376 F. Supp. 2d 472, 508 (S.D.N.Y. 2005) – to support its presumption of reliance in "scheme" cases. In both of these cases, however, the defendants who were held primarily liable were alleged to have actually *made* material misstatements. *See ZZZZ Best*, 864 F. Supp. at 964; *Parmalat*, 376 F. Supp. 2d at 509. In fact, the district court in *Parmalat* explicitly held that

plaintiffs could *not* establish reliance in respect of the defendants who did not make any representations. *See Parmalat*, 376 F. Supp. 2d at 509 ("The bank defendants, however, made no representations in connection with those schemes, at least none relevant here. The plaintiffs therefore cannot be said to have relied on the banks."). Thus, neither the reasoning nor the holdings of either decision offer any support for the notion that reliance can, consistent with *Central Bank*, somehow be presumed in a statements case as to a non-speaking secondary actor merely because a "scheme to defraud" has been alleged.

Central Bank is clear: In order to hold a secondary actor liable for securities fraud, a plaintiff must have relied on *that actor's* conduct. *Central Bank*, 511 U.S. at 180 ("A plaintiff must show reliance on *the defendant's* misstatement or omission to recover under 10b-5.") (emphasis added). In a fraud-on-the-market "statements" case such as this, a plaintiff can only establish reliance because the market relied on the statements of the specific defendant. *See Basic Inc. v. Levinson*, 485 U.S. 224, 241-45 (1988). Unless a secondary actor makes or participates in making a false statement, a plaintiff simply cannot demonstrate reliance on such actor's conduct in furtherance of any "scheme to defraud."

D. The Decision Below Permits Liability for Conduct That Cannot be Viewed as Having Occurred "In Connection With" the Purchase or Sale of Securities.

The Ninth Circuit's decision also is legally defective because it permits liability against secondary actors for conduct that cannot be viewed as having occurred "in connection with" the purchase of sale of any security. *See* 15 U.S.C. § 78j(b) (2006) (section 10(b) liability attaches only to those who "use or employ, *in connection with the purchase or sale of any security* . . . any manipulative or deceptive device or contrivance") (emphasis added).

According to *SEC v. Zandford*, 535 U.S. 813 (2002), in order for the "in connection with" requirement to be satisfied, the challenged conduct at issue must "coincide" with the purchase or sale of a security. *Id.* at 825. Concluding that this requirement was met in *Zandford*, this Court explained:

> The securities sales and respondent's fraudulent practices were not independent events. This is not a case in which, after a lawful transaction had been consummated, a broker decided to steal the proceeds and did so. . . . Rather, *respondent's fraud coincided with the sales themselves.*

Id. at 820 (emphasis added); *see also United States v. O'Hagan*, 521 U.S. 642, 656 (1997) (trading on misappropriated information met the "in connection with" requirement because "[t]he securities transaction and the breach of duty . . . coincide[d]").

Here, it is difficult (if not impossible) to understand how secondary actor conduct, such as entering into business transactions with an issuer, which are later purportedly misrepresented by the issuer on its financial statements, can be viewed as "coinciding with" or occurring "in connection with" the purchase or sale of any security. The business transaction itself – in contrast to an issuer's subsequent misreporting of the transaction on its own publicly issued financial statements – does not deceive investors or otherwise coincide with any subsequent purchase of securities.

The Ninth Circuit attempts to address this glaring problem, but its reasoning is flawed. According to the Ninth Circuit, a "scheme" to misrepresent the publicly reported revenue of a company may "coincide" with the purchase or sale of securities because "the scheme will not be complete until the fraudulent information is introduced into the securities market." (Pet. App. 21a). Thus, because the "scheme to defraud" – viewed as a whole – can be said to have coincided with the purchase or sale of securities, the

Ninth Circuit summarily concluded that "all participants [in the scheme] may be viewed as having acted in connection with the purchase or sale of securities." (Pet. App. 21a).

Such "group" reasoning, however, cannot be reconciled with this Court's precedents. As noted, *Central Bank* was clear that, in order for secondary actors to be primarily liable under Section 10(b), a plaintiff must plead and prove that the conduct of such secondary actors *independently* satisfies *each* element of a violation of Section 10(b). *See Central Bank*, 511 U.S. at 191. The court below ignored this mandate by erroneously concluding that the "in connection with" requirement can be satisfied as against secondary actors in "scheme" cases – regardless of when their *own* conduct in furtherance of the alleged scheme took place – based solely on the later conduct of the issuer defendant (*i.e.*, here, in the words of the Ninth Circuit, introducing "fraudulent information . . . into the securities market"). (Pet. App. 21a).

A correct application of *Zandford* and *Central Bank* is demonstrated by a recent federal district court decision, *In re Dynegy, Inc. Sec. Litig.*, 339 F. Supp. 2d 804 (S.D. Tex. 2004). In that case, plaintiff challenged not only statements made by the issuer defendant Dynegy, but also the conduct of Citigroup, seeking to hold Citigroup liable for allegedly structuring and funding the transactions that Dynegy was alleged to have subsequently misreported on its financial statements. *See id.* at 915-16. Applying *Zandford*, the court concluded that "[b]ecause plaintiffs in this case do not allege any facts showing that Citigroup's allegedly manipulative and deceptive acts coincided with sales of Dynegy securities," *see id.* at 916, the "in connection with" requirement was not independently satisfied in respect of Citigroup, as it must be in order for Citigroup to be primarily liable under *Central Bank*. *See Dynegy*, 339 F. Supp. 2d at 915 (under *Central Bank*, a "secondary actor may not be liable for primary violations under an alleged scheme to defraud unless all of

the requirements for liability under Rule 10b-5 have been satisfied *as to the secondary actor*") (emphasis added).

Thus, as the district court in *Dynegy* properly concluded, secondary actors cannot be held liable under Section 10(b) for a "scheme to defraud" or otherwise where, as here, such actors are alleged to have engaged in conduct one or more steps removed from the relevant securities transactions, because such claims do not satisfy Section 10(b)'s "in connection with" requirement in respect of the secondary actor's conduct.

III. There Are Other Compelling Reasons To Resolve the Circuit Split Now

This case presents an appropriate vehicle for this Court to resolve the Circuit conflict and dispute over whether, consistent with precedents of this Court, secondary actors can be liable for "deceptive" conduct for engaging in a "scheme to defraud" without making misstatements or omissions. Arguments concerning this question will not be refined or resolved by allowing it to percolate further among the Circuit courts. Instead, the question presented is a discrete, well-defined and extremely important issue of law, which has now been decided definitively – in opposite ways – by Ninth Circuit and four other circuit courts post-*Central Bank*.[7]

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7. Additionally, several District Courts also have issued detailed opinions analyzing this issue, reaching differing conclusions. *Compare, e.g., In re Dynegy, Inc. Sec. Litig.*, 339 F. Supp. 2d 804, 916 (S.D. Tex. 2004) ("[P]laintiffs cannot invoke subsections (a) and (c) of Rule 10b5 to circumvent Central Bank's limitations on liability for secondary actor's involvement in the preparation of false and misleading statements."), *with In re Lernout & Hauspie Sec. Litig.*, 236 F. Supp. 2d 161, 172 (D. Mass. 2003) (declining to dismiss claims against secondary actor business partners alleged to have engaged in "sham transactions" about which the issuer later made misstatements); *In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472, 505 (S.D.N.Y. 2005) (same). *See also In re*

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Petitioners respectfully submit that as long as there is at least one forum such as the Ninth Circuit, which has reached a result at odds with *Central Bank*, it will serve as a portal for plaintiffs to bring a species of "aiding and abetting" claims against secondary actors. In open-market securities cases to which the Ninth Circuit's decision will apply, the securities typically at issue are traded nationally, which means plaintiffs can select virtually any forum in which to bring their claims. Entities doing business with a publicly-traded issuer will face the risk of excessive, vexatious litigation because any business transaction can be improperly accounted for by one party to it. *See Central Bank*, 511 U.S. at 189 ("uncertainty" can result in "excessive litigation" and "'litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from . . . litigation in general'") (citation omitted).

There can be little doubt that, if the decision is permitted to stand, lawyers across the nation will begin naming as defendants all manner of companies (particularly companies with "deep pockets,") merely because they engaged in significant business transactions with issuers who allegedly accounted for the transactions fraudulently on their books. Such scenarios should not be allowed to develop, particularly in light of the expensive and often vexatious nature of securities litigation. *See Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 126 S. Ct. 1503, 1510-11 (2006) (discussing "the widespread recognition that 'litigation under Rule 10b-5 presents a danger of vexatiousness different in

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Enron Corp. Securities, Derivative & "ERISA" Litig., 310 F. Supp. 2d 819 (S.D. Tex. 2004); *In re Global Crossing, Ltd. Sec. Litig.*, 322 F. Supp. 2d 319 (S.D.N.Y. 2004); *In re AOL Time Warner, Inc. Sec. & "ERISA" Litig.*, 381 F. Supp. 2d 192 (S.D.N.Y. 2004); *see generally* Peter M. Saparoff & Breton Leone-Quick, *The Debate Over Secondary Actor Liability is Now Before the Circuit Courts*, American Law Institute, at 1000 (May 2006) ("District Courts have been split as to how to address these new types of ["scheme"] pleadings.").

degree and in kind from that which accompanies litigation in general'" such as the "targeting of deep-pocket defendants") (quoting *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 739 (1975)); *see also Santa Fe Indus.*, 430 U.S. at 478-79 (declining to interpret Section 10(b) in a manner that would "pos[e] a danger of vexatious litigation") (citation omitted). *Cf. Ernst & Ernst*, 425 U.S. at 214 n.33 ("[W]e are not the first court to express concern that the inexorable broadening of the class of plaintiff who may sue in this area of the law will ultimately result in more harm than good.") (quoting *Blue Chip Stamps*, 421 U.S. at 747-48).

Other important policy considerations also counsel strongly in favor of granting this Petition at this time. In *Central Bank*, this Court observed that the area of securities law "'demands certainty and predictability.'" *Central Bank*, 511 U.S. at 188 (citation omitted). Thus, "'a shifting and highly fact-oriented disposition of the issue of who may [be liable for] a damages claim for violation of Rule 10b-5' is not a 'satisfactory basis for a rule of liability imposed on the conduct of business transactions.'" *Id.* (citation omitted; alteration in original). But the Ninth Circuit's decision revives the very "uncertainty" that this Court sought to eliminate in *Central Bank*. *Id.* at 189. For example, attempting to distinguish its holding from *Central Bank* and mere "aiding and abetting" liability, the Ninth Circuit states:

> It is not enough that a transaction in which a defendant was involved had a deceptive purpose and effect; the defendant's own conduct contributing to the transaction or overall scheme must have had a deceptive purpose and effect. . . . Thus, when determining whether a defendant is a 'primary violator,' the conduct of each defendant, *while evaluated in its context, must be viewed alone* for whether it had the purpose and effect

> of creating a false appearance of fact in the furtherance of an overall scheme to defraud.

Op. at 7249-50 (emphasis added).

This standard is the antithesis of certainty and predictability. It has bred litigation against business partners, investment banking firms, lawyers, and others in the Ninth Circuit and in the district courts. These are precisely the entities that *Central Bank* held should not be part of Section 10(b) litigation because they neither make statements to investors nor have a duty to speak to investors. *Central Bank* taught that it is "undesirable" to have "decisions 'made on an ad hoc basis, offering little predictive value' to those who provide services to participants in the securities business." 511 U.S. at 188 (citation omitted).

In an area of law that "demands certainty and predictability," *id.*, a party should *not* be forced to worry about entering into a transaction with a publicly-traded issuer because the issuer may decide to record the transaction inaccurately on its financial statements. Further, employees of a publicly-traded issuer who are not involved in the issuance or preparation of financial statements should not face the specter of litigation merely because a transaction in which they were involved in a non-accounting role is subsequently accounted for improperly by others on the issuer's financial statements. Yet so long as the decision below remains unreviewed, such a possibility will become a factor to assess each and every time a third party is considering a business transaction with a publicly traded issuer, because plaintiffs could always later challenge the "principal purpose" of the transaction. If business enterprises are forced to deal with such issues, transaction costs will undoubtedly increase and get passed on to a company's investors. *See Central Bank*, 511 U.S. at 189 (declining to expand the scope of securities fraud liability in part because the resulting "uncertainty and excessive litigation" could lead

to increased costs for companies that ultimately may be "incurred by the company's investors, the intended beneficiaries of the statute").

This case is illustrative of that danger. In order to prevail on the legal merits in the courts below, Petitioners will have had to win at least four rounds of briefing: the original dismissal ruling, the Ninth Circuit's decision, the remand, and an inevitable appeal after remand. And, if the district court erroneously rules against Petitioners on remand, Petitioners would have no appeal as of right as to that decision until after costly discovery and a trial. Rather than face similar costs and risks, many non-speaking defendants who are unable to prevail at the threshold, motion to dismiss stage will settle, passing on costs to issuers and ultimately investors in future transactions. This Court has warned against the deleterious effect of such settlements. *See Dura*, 544 U.S. at 347; *Central Bank*, 511 U.S. at 189. This Court's immediate review is necessary to prevent the continuation of vexatious litigation and unmerited settlements. Indeed, this Court has previously granted certiorari to resolve important Section 10(b) civil liability issues in cases involving circuit court decisions that, as here, improperly remanded District Court decisions granting Rule 12(b)(6) dismissals of complaints with prejudice. *See Dabit*, 126 S. Ct. at 1507 (SLUSA preemption); *Dura*, 544 U.S. at 340 (loss causation); *Santa Fe Indus. v. Green*, 430 U.S. 462, 469 (1977) (§ 10(b) does not apply to mismanagement); *Blue Chip Stamps*, 421 U.S. at 727 (Section 10(b) plaintiffs are limited to actual purchasers and sellers).

CONCLUSION

For the foregoing reasons, the petition for writ of *certiorari* should be granted.

Respectfully submitted,

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APPENDIX

APPENDIX A — OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT FILED JUNE 30, 2006

UNITED STATES COURT OF APPEALS NINTH CIRCUIT

No. 04-55665.

T. Jeffrey SIMPSON, on behalf of himself and all others similarly situated,

Plaintiff,

and

California State Teachers Retirement System,

Plaintiff-Appellant,

v.

AOL TIME WARNER INC.; Cendant Corporation; Richard A. Smith; L90, aka Max Worldwide; David Colburn; Eric Keller,

Defendants-Appellees.

Argued and Submitted Feb. 6, 2006.
Filed June 30, 2006.

Appeal from the United States District Court for the Central District of California; Marsha J. Pechman, District Judge, Presiding. D.C. No. CV-01-11115-MJP.

Appendix A

Before BEEZER, T.G. NELSON, and GOULD, Circuit Judges.

GOULD, Circuit Judge.

This consolidated class action litigation alleges that multiple actors engaged in a scheme to commit securities fraud by overstating the reported revenues of an Internet company, Homestore.com ("Homestore"). Homestore eventually restated its revenues, resulting in a decrease in revenues of more than $170 million and corresponding declines in Homestore's stock value. The district court dismissed the securities claims against Defendants-Appellees, relying on the Supreme Court's decision in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 114 S.Ct. 1439, 128 L.Ed.2d 119 (1994).

In this appeal, the lead plaintiff, California State Teachers' Retirement System ("CalSTRS" or "Plaintiff"), seeks to reverse the district court's dismissal with prejudice of its claims under § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), against six outside defendants ("Defendants"): AOL Time Warner ("AOL") and two of its officers, Eric Keller and David Colburn; Cendant Corporation and one of its officers, Richard Smith; and L90, Inc. ("L90"). Plaintiff alleges Homestore entered into fraudulent transactions with these Defendants in which Homestore purchased revenue for itself and then recorded that revenue in violation of SEC accounting rules. In the alleged "triangular transactions," Homestore entered into sham transactions with "Third Party Vendors" who then returned

the money to Homestore through contracts with AOL or L90. Plaintiff alleges Homestore overpaid for an asset owned by Cendant in return for Cendant's agreement that it would funnel some of the money back to Homestore through a related business entity. The complaint further alleged that the recording of gross revenue from these transactions contravened SEC rules regarding barter transactions or the buying of revenue, and that the triangular transactions were often done without the full knowledge of Homestore's auditor.

The Supreme Court held in *Central Bank* that § 10(b) does not allow recovery for aiding and abetting liability, *Cent. Bank,* 511 U.S. at 177-78, 114 S.Ct. 1439, but cautioned that secondary actors were not always free from liability under § 10(b) because they may still be liable as a primary violator. 511 U.S. at 191, 114 S.Ct. 1439. We address here the scope of primary violation liability that the Supreme Court did not fully define in *Central Bank.*

Plaintiff asserts that Defendants are primary violators under § 10(b) for engaging in a "scheme to defraud." In response, Defendants argue that the Supreme Court in *Central Bank* limited primary liability under § 10(b) to defendants who personally made a public misstatement, violated a duty to disclose or engaged in manipulative trading activity, and not to those engaged in a broader scheme to defraud. Although we hold that the scope of § 10(b) includes deceptive conduct in furtherance of a "scheme to defraud," when all elements of § 10(b) are otherwise satisfied, we conclude that Plaintiff's complaint insufficiently alleged that Defendants were primary violators of § 10(b) based on their conduct in the furtherance of the scheme.

Appendix A

I

CalSTRS alleges in its First Amended Consolidated Complaint ("FACC") that Homestore and its officers, along with its auditor PriceWaterhouseCoopers ("PWC"), AOL, Cendant, L90, and additional Third Party Vendors, committed securities fraud by engaging in round-trip or barter transactions whereby Homestore recorded net revenues from its receipt of monies that came from Homestore's own cash reserves.

Homestore created an online real estate website in 1996. In the late 1990s, there was an explosion of Internet start-up companies which consistently posted net losses and negative cash flows as those companies sought to develop leadership and market share in their industries. This development caused a corresponding shift in emphasis by financial analysts to the tracking and evaluation of revenues as an indicator of future earnings. Until 2001, Homestore was perceived as an Internet company that consistently matched or exceeded its estimated revenue goals. To meet its revenue expectations, Homestore relied increasingly on barter or round-trip transactions with other companies. In such transactions, Homestore paid a company, the company returned part of the money to Homestore by way of a different transaction, and Homestore recorded these returned funds as revenue.

Internet companies have historically engaged in barter transactions between themselves, often in order to place advertising on each other's websites. Beginning in fiscal year 2000, the SEC implemented a new accounting standard that required companies engaging in barter transactions to report

only the net revenue that was earned from these related transactions, rather than the gross revenue received. Facing increasing scrutiny from its auditor PWC, Homestore's barter transactions grew more complex. Homestore engaged in triangular transactions, with the result that PWC did not recognize that the revenue that Homestore recorded was related to a prior transaction funded by Homestore. As the district court succinctly summarized, in these triangular transactions:

> Homestore would find some third party corporation, one that was thinly capitalized and in search of revenues in order to "go public." Homestore then agreed to purchase shares in that company for inflated values or to purchase services or products that Homestore did not need. This transaction was contingent on the third party company "agreeing" to buy advertising from AOL for most or all of what Homestore was paying them. The money thus flowed through the third party to AOL, which then took a commission and shared "revenue" with Homestore.

In re Homestore.com, Inc. Securities Litigation, 252 F.Supp.2d 1018, 1023 (C.D.Cal.2003). Against this background, we consider the allegations against the particular Defendants.

A. Allegations Involving AOL, and its officers Keller and Colburn

The history of Homestore and AOL for purposes of this appeal began with the creation of a legitimate partnership in April 1998, whereby Homestore purchased the "exclusive

right to have the only online real estate listing product on AOL." In a second legitimate deal with AOL, Homestore entered into an advertising reseller agreement, under which AOL agreed in March 1999 to sell advertising on the Homestore website and retain a commission.

The triangular transactions at issue here occurred during the first two quarters of fiscal year 2001. Plaintiff alleges that Homestore entered into a series of sham transactions with various Third Party Vendors for some product or service that Homestore did not need. The Third Party Vendors would then contract with AOL for advertising on Homestore's website and AOL would give this money back to Homestore under their advertising reseller agreement. Both the Third Party Vendors and AOL would keep a portion of the money as a commission. Plaintiff only alleges that the first leg of the transaction was truly a sham because nothing of value was given in exchange for Homestore's payment. AOL continued to sell advertising on Homestore's website to Third Party Vendors, withholding commissions before passing the Vendors' payments on to Homestore.

Plaintiff alleges that Defendant Eric Keller, as an employee of AOL, jointly developed these transactions with Homestore. Keller was also alleged to have contacted some of the Third Party Vendors that took part in these triangular transactions. Plaintiff alleges, without detailed support, that Defendant Colburn, Keller's supervisor, approved the improper transactions. AOL placed Keller on administrative leave in June 2001. AOL then attempted to include more accurate documentation of the round trip nature of additional triangular transactions that occurred at the close of the second

quarter of 2001. Homestore convinced AOL to accept less descriptive documents, which would not alert PWC to the nature of the round-trip transaction. AOL included a list of the "potential referral advertisers" as part of the second deal in 2001, but let Homestore add other companies not involved in the round-trip transactions so that the Third Party Vendors could not be identified.

B. Allegations Involving Cendant and its officer Smith

Cendant Corporation is a conglomerate with holdings in real estate, travel, and vehicle rentals. In 2001, it owned Move.com, the second largest real estate internet website after Homestore. Cendant sold Move.com to Homestore in the first quarter of 2001. In exchange for the site, Homestore transferred $750 million worth of Homestore stock to Cendant and placed Cendant's president, Richard Smith, on Homestore's board of directors. Plaintiff alleges that, although an outside firm appraised the site, Homestore "grossly overpaid" Cendant for this website, which Cendant considered a "bad asset."

Plaintiff alleges that the Move.com transaction was contingent on a promise by Cendant to recycle some of Homestore's payment for Move.com back to Homestore. To accomplish this, Cendant set up a separate corporate entity, the Real Estate Technology Trust ("RETT"), and funded it with $95 million. Cendant, through RETT, then agreed to the payment of $80 million over two years in exchange for products and services from Homestore. There are no allegations that Cendant made efforts to conceal the contingent nature of these transactions.

Appendix A

According to the allegations in the FACC, Cendant later agreed to use the remaining $15 million in RETT to purchase virtual tours from Homestore. At first, Cendant proposed a reciprocal agreement in which Homestore would purchase $15 million in products from Cendant at a later date. Homestore refused because this reciprocal transaction would prevent PWC from allowing Homestore to report the first $15 million as revenue. Cendant then dropped the reciprocal requirement and purchased the tours.

C. Allegations Involving L90

L90 entered into triangular transactions with Homestore and various third parties during the second and third quarters of 2001. These transactions followed the business model created with AOL's participation.[1] At the end of the third quarter of 2001, PWC required a confirmation letter from L90 before it would certify Homestore's 10-Q filing. Initially, Mark Roah, a corporate officer for L90, refused to sign the confirmation letter. Fearing personal liability, Roah requested payment from Homestore and said that he wanted only to do "legitimate deals" with the company. Roah later dropped his demands and confirmed the revenue, but shortly thereafter Homestore's Chief Financial Officer Joseph Shew refused to sign the Form 10-Q report that included the revenues Roah had confirmed. Homestore then announced that it would restate its financial results to reflect lower revenue.

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1. There are no allegations that L90 or its officers helped to develop these transactions such as Keller was alleged to have done.

Appendix A

D. Procedural History

Multiple class action complaints were filed between December 27, 2001, and February 13, 2002. These complaints were consolidated on February 22, 2002. On September 25, 2002, Homestore's former Chief Operating Officer, John Giesecke; former Chief Financial Officer, Joseph Shew; and Vice President of Finance, John DeSimone, pled guilty to securities fraud violations. On November 15, 2002, Plaintiff filed the FACC, which relied on the details recited in the plea agreements for these officers. Homestore and Peter Tafeen, former Executive Vice President of Business Development and Sales, answered the FACC, but all other defendants moved to dismiss. On March 7, 2003, the district court denied the motions to dismiss for Stuart Wolff, Homestore's former CEO, and its auditor PWC. The district court dismissed without prejudice the complaint as to the remaining Homestore insider defendants. Relevant to this appeal, the district court also dismissed the complaint as to the outside defendants with prejudice.

In dismissing the complaint against the outside defendants, which it referred to as the "Business Partner Defendants," the district court observed that in previous cases in which courts found primary liability, a special relationship existed between the defendants and the shareholders. The district court ultimately determined that the outside defendants did not commit a primary violation because they only facilitated and participated in Homestore's fraud. The district court also determined that Plaintiff had not demonstrated reliance because the shareholders did not rely on the outside defendants' scheme but only on the statements made about the scheme by Homestore.

Appendix A

II

We review de novo the dismissal of claims pursuant to Federal Rule of Civil Procedure 12(b)(6). *Decker v. Advantage Fund, Ltd.*, 362 F.3d 593, 595-96 (9th Cir.2004). We may affirm a dismissal on any basis fairly supported by the record, even if the district court did not reach the issue or relied on different grounds or reasoning. *Adams v. Johnson*, 355 F.3d 1179, 1183 (9th Cir.2004). "All allegations and reasonable inferences are taken as true, and the allegations are construed in the light most favorable to the non-moving party, but conclusory allegations of law and unwarranted inferences are insufficient to defeat a motion to dismiss." *Id.* (internal quotations omitted). "Dismissal is proper under Rule 12(b)(6) if it appears beyond doubt that the non-movant can prove no set of facts to support its claims." *Id.* "The district court's dismissal of a complaint without leave to amend is reviewed de novo and is improper unless it is clear that the complaint could not be saved by any amendment." *Livid Holdings Ltd. v. Salomon Smith Barney, Inc.*, 416 F.3d 940, 946 (9th Cir.2005).

Securities fraud must be pled with specificity. In the Private Securities Litigation Reform Act ("PSLRA"), Congress required that "a complaint must 'specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.'" *Lipton v. Pathogenesis Corp.*, 284 F.3d 1027, 1034 (9th Cir.2002) (quoting 15 U.S.C. § 78u-4(b)(1)). In addition, all allegations of deceptive

conduct are generally subject to Federal Rule of Civil Procedure 9(b), which requires that "the circumstances constituting fraud or mistake shall be stated with particularity."

III

We determine whether the Defendants' conduct, as alleged, is a primary violation of § 10(b). Section 10(b) prohibits, in pertinent part, "any person, directly or indirectly, . . . [t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe." Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b). To implement § 10(b), the SEC promulgated Rule 10b-5, 17 CFR § 240.10b-5. Rule 10b-5 is composed of three parts that describe the type of conduct prohibited by § 10(b). The second part proscribes the making of "any untrue statement of a material fact" or the omission of any material fact that is necessary in order to make the statements made not misleading. Rule 10b-5(b), 17 CFR § 240.10b-5(b). The first and third parts make it unlawful for any person "to employ any device, scheme, or artifice to defraud" or "to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person." Rule 10b-5(a) & (c), 17 CFR § 240.10b-5(a) & (c).

Liability under Rule 10b-5 does not extend beyond the limits of § 10(b). *See Cent. Bank,* 511 U.S. at 173, 114 S.Ct. 1439 ("But the private plaintiff may not bring a 10b-5 suit against a defendant for acts not prohibited by the text of

§ 10(b)."); *Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 214, 96 S.Ct. 1375, 47 L.Ed.2d 668 (1976) ("Thus, despite the broad view of the Rule advanced by the Commission in this case, its scope cannot exceed the power granted the Commission by Congress under § 10(b)."). In *Central Bank,* the Supreme Court held "that the text of the 1934 Act does not itself reach those who aid and abet a § 10(b) violation." 511 U.S. at 177, 114 S.Ct. 1439; *see also id.* at 177-78, 114 S.Ct. 1439 ("We cannot amend the statute to create liability for acts that are not themselves manipulative or deceptive within the meaning of the statute."). The Court cautioned, however, that secondary actors, other than the securities issuer, may be liable as primary violators under § 10(b) when all elements of the statute are satisfied:

> The absence of § 10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability under the securities Acts. Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming *all* of the requirements for primary liability under Rule 10b-5 are met.

Cent. Bank, 511 U.S. at 191, 114 S.Ct. 1439.

A private action under § 10(b) and Rule 10b-5 must allege and prove all of the elements for primary liability for each defendant. The elements of a securities fraud claim are:

(1) to use or employ any manipulative or deceptive device or contrivance; (2) scienter, *i.e.* wrongful state of mind; (3) a connection with the purchase or sale of a security; (4) reliance, often referred to in fraud-on-the-market cases as "transaction causation;" (5) economic loss; and (6) loss causation, *i.e.* a causal connection between the manipulative or deceptive device or contrivance and the loss. *See Dura Pharmaceuticals, Inc. v. Broudo,* 544 U.S. 336, 341-42, 125 S.Ct. 1627, 161 L.Ed.2d 577 (2005).

The district court and the parties have questioned the sufficiency of the allegations concerning three elements: (1) the use or employment of a deceptive device or contrivance by the Defendants; (2) in connection with the purchase or sale of securities; (3) that has been relied upon by the public.[2]

A. The Use or Employment of a Deceptive Device or Contrivance

The Supreme Court tells us that § 10(b) is intended to prohibit the use or employment of any deceptive device in connection with the purchase or sale of securities, including deception as part of a larger scheme to defraud the securities market. *See Ernst & Ernst,* 425 U.S. at 199 n. 20, 96 S.Ct.

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2. We do not consider the possibility of liability based on actionable omissions or manipulation sufficient to satisfy the requirement of a "manipulative or deceptive device or contrivance" under § 10(b). There are no allegations that any Defendant was subject to a duty to disclose in the context of these transactions or engaged in manipulative trading activity. *See Santa Fe Indus., Inc. v. Green,* 430 U.S. 462, 476, 97 S.Ct. 1292, 51 L.Ed.2d 480 (1977).

1375 (defining "device" as "an invention; project; scheme; often, a scheme to deceive"); *Superintendent of Ins. v. Bankers Life & Cas. Co.,* 404 U.S. 6, 10 n. 7, 92 S.Ct. 165, 30 L.Ed.2d 128 (1971) ("'We believe that § 10(b) and Rule 10b-5 prohibit all fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception.'" (quoting *A.T. Brod & Co. v. Perlow,* 375 F.2d 393, 397 (2d Cir.1967))). The Supreme Court has also held that a non-speaking actor who engages in a "scheme to defraud" has used or employed a deceptive device within the meaning of § 10(b). *See SEC v. Zandford,* 535 U.S. 813, 821-22, 122 S.Ct. 1899, 153 L.Ed.2d 1 (2002).

In *Central Bank,* the Supreme Court held that liability under § 10(b) only extends to "primary violators" and there is no liability for merely "aiding and abetting" a violation. 511 U.S. at 191, 114 S.Ct. 1439. Since *Central Bank,* it is the duty of courts to determine what constitutes a "primary violation" of § 10(b). With respect to the making of false statements or omissions, we have held that "substantial participation or intricate involvement in the preparation of fraudulent statements is grounds for primary liability even though that participation might not lead to the actor's actual making of the statements." *Howard v. Everex Sys., Inc.,* 228 F.3d 1057, 1061 n. 5 (9th Cir.2000); *see id.* at 1061 (holding that signing and attesting to a statement, such that for all intents and purposes the signor-attestor made the statement, is sufficient to be considered a primary violator); *see also In re Software Toolworks Inc. Sec. Litig.,* 50 F.3d 615, 628-29 & n. 3 (9th Cir.1994) (holding that drafting or editing false

statements that the drafter-editor knows will be publicly disseminated is sufficient to be considered a primary violator).

What it means to be a "primary violator" with respect to an alleged "scheme to defraud" has been less extensively discussed. In *Cooper v. Pickett,* 137 F.3d 616, 624 (9th Cir.1997), we held that to be liable for a "scheme to defraud," "each defendant [must have] committed a manipulative or deceptive act in furtherance of the scheme." The relevant inquiry is: what conduct constitutes a manipulative or deceptive act in the furtherance of a scheme to defraud sufficient to render the defendant a "primary violator" of § 10(b)?

The SEC argues in its amicus brief that "Any person who directly or indirectly engages in a manipulative or deceptive act as part of a scheme to defraud can be a primary violator."[3] The SEC defines "a deceptive act" as "engaging in a transaction whose principal purpose and effect is to create a false appearance of revenues." We agree with the SEC that engaging in a transaction, the principal purpose and effect of which is to create the false appearance of fact, constitutes

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3. The arguments of the SEC are only persuasive authority to the extent that they are reasonable in light of the statutory authority. *See Zandford,* 535 U.S. at 819-20, 122 S.Ct. 1899 ("[The SEC's] interpretation of the ambiguous text of § 10(b), in the context of formal adjudication, is entitled to deference if it is reasonable"). To the extent that the SEC's proposed test purports to include aiding and abetting or coconspirator liability, we are constrained to reject it. *See In re GlenFed, Inc. Sec. Litig.,* 60 F.3d 591, 592 (9th Cir.1995).

a "deceptive act."[4] Participation in a fraudulent transaction by itself, however, is insufficient to qualify the defendant as a "primary violator" if the deceptive nature of the transaction or scheme was not an intended result, at least in part, of the defendant's own conduct. We hold that to be liable as a primary violator of § 10(b) for participation in a "scheme to defraud," the defendant must have engaged in conduct that had the principal purpose and effect of creating a false appearance of fact in furtherance of the scheme. It is not enough that a *transaction* in which a defendant was involved had a deceptive purpose and effect; the defendant's *own conduct* contributing to the transaction or overall scheme must have had a deceptive purpose and effect.[5]

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4. "The consideration of purpose and effect of challenged actions not infrequently assists in determining whether a prohibition is to be applied to complex conduct . . . [and its] importance . . . [in] judg[ing] the legality of challenged action is also a recurring theme in statutory law." *The Wilderness Soc'y v. U.S. Fish & Wildlife Serv.*, 353 F.3d 1051, 1064 (9th Cir.2003).

5. The "principal purpose" prong is related to but different from the element of scienter. For the element of scienter, we require "that a private securities plaintiff proceeding under the PSLRA must plead, in great detail, facts that constitute strong circumstantial evidence of deliberately reckless or conscious misconduct." *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 974 (9th Cir.1999). Previous cases have found the scienter requirement satisfied by indirect evidence of a culpable state of mind, such as suspicious insider trading activity or knowledge of accounting violations. *See In re Daou Systems, Inc.*, 411 F.3d 1006, 1017 (9th Cir.2005); *Silicon Graphics*, 183 F.3d at 986. While the scienter element ensures a culpable state of mind and must be satisfied for recovery under § 10(b), the "principal purpose" prong examines instead whether

(Cont'd)

Defendants argue that imposing liability for participation in an overall scheme to defraud would impose liability for conduct other than the making of a material misstatement or omission and would conflict with *Central Bank*. We disagree. We see no justification to limit liability under § 10(b) to only those who draft or edit the statements released to the public. To the contrary, § 10(b) prohibits any person or entity from using or employing any deceptive device, directly or indirectly, in connection with the purchase and sale of securities. *See* Robert A. Prentice, *Locating That "Indistinct" and "Virtually Nonexistent" Line Between Primary and Secondary Liability under Section 10(b)*, 75 N.C. L.Rev. 691, 731 (1997) (asserting that "the view that one can be liable only for one's own statements arguably ignores the fact that

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(Cont'd)

the challenged conduct of the defendant had a principal purpose, and not just an accidental effect, of creating a false appearance as part of a deceptive transaction or fraudulent scheme. Unlike the scienter requirement, the "purpose and effect" test is focused on differentiating conduct that may form the basis of a primary violation under § 10(b) from mere aiding and abetting activity that the Supreme Court has held does not constitute a primary violation. A defendant may intend to deceive the public by substantially assisting another's misconduct as part of a scheme to defraud, but fail to perform personally any action that created a false appearance as part of this scheme. The scienter requirement, therefore, will not in all cases distinguish aiding and abetting from primary liability. In applying the "scienter" element, we look at whether a defendant's state of mind was sufficiently culpable for § 10(b) liability. By contrast, we may examine the "principal purpose and effect" of the defendant's challenged conduct in a fraudulent scheme as an aid to assessing whether the defendant's conduct was sufficiently deceptive for § 10(b) liability.

both Section 10(b) and Rule 10b-5 condemn those who employ devices or make misstatements 'directly or indirectly' "). Furthermore, § 10(b) "should be construed not technically and restrictively, but flexibly to effectuate its remedial purposes." *Zandford,* 535 U.S. at 819, 122 S.Ct. 1899 (internal quotation marks omitted). Nor is "scheme to defraud" liability a substitute for aiding and abetting liability that the Supreme Court precludes in *Central Bank.* The focus of the inquiry on the deceptive nature of the defendant's own conduct ensures that only primary violators (that is, only those defendants who use or employ a manipulative or deceptive device) are held liable under the Act.

Trial courts which have imposed liability under a "scheme to defraud" theory have often required that the defendant's actions in fraudulent transactions have a principal purpose and effect of creating a false appearance of fact in furtherance of the scheme to defraud. *See Quaak v. Dexia S.A.,* 357 F.Supp.2d 330, 342 (D.Mass.2005) (finding sufficient allegations for primary liability under § 10(b) when "defendant was a primary architect of the scheme to finance the sham entities"); *In re Global Crossing, Ltd. Sec. Litig.,* 322 F.Supp.2d 319, 336-337 (S.D.N.Y.2004) (allowing claims of primary liability to go forward where auditors "masterminded" company's misleading accounting practices); *In re Lernout & Hauspie Sec. Litig.,* 236 F.Supp.2d 161, 173 (D.Mass.2003) (denying a motion to dismiss for outside business partners who invented sham corporate entities that allowed a corporation "to hide research and development expenses, create fictitious revenue, and ultimately overstate profits in [its] financial reports").

Appendix A

Conduct by the defendant that does not have a principal legitimate business purpose, such as the invention of sham corporate entities to misrepresent the flow of income, may have a principal purpose of creating a false appearance. *See In re Enron Corp. Sec., Derivative & "ERISA" Litig.*, 310 F.Supp.2d 819, 830 (S.D.Tex.2004) ("Sham business transactions with no legitimate business purpose that are actually guaranteed 'loans' employed to inflate Enron['s] financial image are not above-board business practices."). Conduct that is consistent with the defendants' normal course of business would not typically be considered to have the purpose and effect of creating a misrepresentation. *See In re Enron Corp. Sec., Derivative & ERISA Litig.*, 235 F.Supp.2d 549, 580 (S.D.Tex.2002) (finding that "conclusory allegations that are consistent with the normal activity of such a business entity, standing alone, . . . are insufficient to state a claim of primary liability under *Central Bank*" (internal quotation marks omitted)). Participation in a legitimate transaction, which does not have a deceptive purpose or effect, would not allow for a primary violation even if the defendant knew or intended that another party would manipulate the transaction to effectuate a fraud. *See In re Charter Commc'ns, Inc., Sec. Litig.*, 443 F.3d 987, 992 (8th Cir.2006) (refusing to impose primary liability "on a business that entered into an arm's length non-securities transaction with an entity that then used the transaction to publish false and misleading statements to its investors and analysts"); *In re Parmalat Sec. Litig.*, 376 F.Supp.2d 472, 505 (S.D.N.Y.2005) ("At worst, the banks designed and entered into the transactions knowing or even intending that Parmalat or its auditors would misrepresent the nature of the arrangements. That is, they substantially assisted fraud

with culpable knowledge-in other words, they aided and abetted it.").

If a defendant's conduct or role in an illegitimate transaction has the principal purpose and effect of creating a false appearance of fact in the furtherance of a scheme to defraud, then the defendant is using or employing a deceptive device within the meaning of § 10(b). A test that examines the purpose and effect of a defendant's conduct in an alleged scheme to defraud, as a means to assess whether the defendant used or employed a deceptive device, ensures that the defendant's conduct is sufficiently deceptive to justify imposing primary liability. Thus, when determining whether a defendant is a "primary violator," the conduct of each defendant, while evaluated in its context, must be viewed alone for whether it had the purpose and effect of creating a false appearance of fact in the furtherance of an overall scheme to defraud.

B. In Connection with the Purchase or Sale of Securities

In addition to the use or employment of a deceptive or manipulative device or contrivance, § 10(b) requires that the primary violation must be "in connection with the purchase or sale of any security." 15 U.S.C. § 78j. In *Zandford,* the Supreme Court held that a broker's misappropriation of a brokerage account was a fraudulent "scheme to defraud" that was "in connection with" the sale of securities despite lacking any deception about the value of a security or "manipulation of a particular security." *Zandford,* 535 U.S. at 821, 122 S.Ct. 1899. In *Zandford,* the broker fraudulently wrote checks to

himself from a brokerage account that required the sale of securities in order to cash the checks. *See id.* Although the misappropriation of money did not affect the securities market until the check was later redeemed, the broker's scheme to defraud was not complete until the victim's securities were sold and the check was redeemed. *See id.* The Supreme Court held that the scheme to defraud "coincided" with the sale of securities, which satisfied the "in connection with" requirement of § 10(b). *Id.* at 820, 122 S.Ct. 1899.

Similarly, a scheme to misrepresent the publicly reported revenue of a company may coincide with the purchase or sale of securities because the scheme will not be complete until the fraudulent information is introduced into the securities market. That every participant in the scheme did not release the information to the public does not diminish the causal connection between all defendants in the scheme and the securities market. *See Cent. Bank,* 511 U.S. at 191, 114 S.Ct. 1439 (stating that "[i]n any complex securities fraud, moreover, there are likely to be multiple violators"). If multiple participants used or employed a deceptive device in furtherance of a scheme to misrepresent the reported revenues of a company, then all participants may be viewed as having acted in connection with the purchase or sale of securities.

C. Reliance

Another requirement for liability under § 10(b) is reliance. *See Cent. Bank,* 511 U.S. at 180, 114 S.Ct. 1439. "Reliance provides the requisite causal connection between

a defendant's misrepresentation and a plaintiff's injury." *Basic Inc. v. Levinson,* 485 U.S. 224, 243, 108 S.Ct. 978, 99 L.Ed.2d 194 (1988). A plaintiff may be presumed to have relied on a misrepresentation if the misleading or false information was injected into an efficient market. "Indeed, nearly every court that has considered the proposition has concluded that where materially misleading statements have been disseminated into an impersonal, well-developed market for securities, the reliance of individual plaintiffs on the integrity of the market price may be presumed." *Id.* at 247, 108 S.Ct. 978. The fraud-on-the-market presumption requires the dissemination of the misrepresentation into an efficient market, but not personal involvement by the defendant in disseminating this statement. *See Knapp v. Ernst & Whinney,* 90 F.3d 1431, 1436 (9th Cir.1996) ("Because a material misrepresentation or omission is generally embedded in the market price of the security, an investor who purchases or sells the security will have presumably relied on the misrepresentation.").

The requirement of reliance is satisfied if the introduction of misleading statements into the securities market was the intended end result of a scheme to misrepresent revenue. *See In re ZZZZ Best Sec. Litig.,* 864 F.Supp. 960, 973 (C.D.Cal.1994) ("Instead, the market's overall reliance on the Z Best fraudulent scheme, or at least the additional statements as released and issued by Z Best, is sufficient to satisfy the reliance element in the Rule 10b-5(a) & (c) claims."); *see also* 4 Alan R. Bromberg & Lewis D. Lowenfels, *Bromberg & Lowenfels on Securities Fraud* § 7:469 (2d ed. 2006) ("Despite some earlier disagreement, it now seems settled that FOMT [the fraud-on-the-market-

theory] applies to all three clauses of Rule 10b-5: (1) scheme to defraud, (2) misrepresentation or omission, and (3) fraudulent course of business, not just to clauses (1) and (3)."). The scheme to defraud would not be complete until the fraudulent information has entered the securities market. *See Parmalat,* 376 F.Supp.2d at 509 ("The banks made no relevant misrepresentations to those markets, but they knew that the very purpose of certain of their transactions was to allow Parmalat to make such misrepresentations. In these circumstances, both the banks and Parmalat are alleged causes of the losses in question."). We may presume, absent persuasive conflicting evidence, that purchasers relied on misstatements produced by a defendant as part of a scheme to defraud, even if the defendant did not publish or release the misrepresentations directly to the securities market.

We conclude that conduct by a defendant that had the principal purpose and effect of creating a false appearance in deceptive transactions as part of a scheme to defraud is conduct that uses or employs a deceptive device within the meaning of § 10(b). Furthermore, such conduct may be in connection with the purchase or sale of securities if it is part of a scheme to misrepresent public financial information where the scheme is not complete until the misleading information is disseminated into the securities market. Finally, a plaintiff may be presumed to have relied on this scheme to defraud if a misrepresentation, which necessarily resulted from the scheme and the defendant's conduct therein, was disseminated into an efficient market and was reflected in the market price.

IV

With these principles in mind, we address the adequacy of the allegations of the FACC at issue here. If the Defendants' conduct, as alleged in the FACC, had the purpose and effect of creating a false appearance from illegitimate transactions in furtherance of a scheme to misrepresent revenues, then Plaintiff has alleged a primary violation of § 10(b). If the relevant actions by the Defendants were not deceptive, however, but only facilitated or assisted the fraudulent misreporting of legitimate transactions by Homestore, then Defendants were not primary violators under § 10(b) and this complaint was correctly dismissed.

A. Primary Liability of America Online (AOL) and its officers

AOL and its officers are alleged to have played a role in the scheme to overstate the revenues of Homestore. According to the FACC, Eric Keller, a Senior Vice President at AOL, helped Homestore to organize and create the triangular transactions. The FACC further alleges that the triangular transactions were necessary to allow Homestore to overstate its revenues, and that the actions of AOL, Colburn and Keller assisted Homestore in misrepresenting the revenues from these transactions. But primary liability requires more than assertions of "helping" or "assisting" another's deception. To allege a primary violation, the complaint must allege that AOL or its officers actually engaged in a deceptive act. We have examined the specific allegations involving AOL and its officers to determine whether the FACC alleges conduct by the AOL Defendants

that had the purpose and effect of creating a false appearance in fraudulent transactions that were part of a scheme to defraud. We conclude that the allegations are insufficient.

It is not alleged that AOL or its officers created sham business entities or engaged in deceptive conduct as part of illegitimate transactions, and so we conclude that the element of using or employing a deceptive device is not adequately alleged in this respect. There is no indication from the FACC that the transactions engaged in by AOL were completely illegitimate or in themselves created a false appearance.[6] The substance of the allegations shows that AOL's role in the transactions was to act as a conduit for the flow of revenue between the Third Party Vendors and Homestore as an advertising agent, in accord with AOL's advertising reseller agreement with Homestore.

The FACC does allege that Homestore entered into sham transactions with "Third Party Vendors" in return for a "quid pro quo" obligation from these vendors to buy Homestore advertising from AOL. Assuming the truth of allegations that no products of value were exchanged between the Third Party Vendors and Homestore, the FACC nonetheless does not allege that AOL itself entered into a transaction that had no legitimate economic value or created a false appearance. While the advertising transactions between the Third Party Vendors and AOL are alleged to contain suspect qualities,

6. Defendants urge that the challenged transactions were not deceptive, and that only the reporting of revenues from these transactions by Homestore, conduct in which Homestore was not assisted by the Defendants, deceived the investing public about revenues of Homestore.

such as exaggerated commissions by AOL, there is no suggestion that actual advertisements were not purchased and sold by these companies. The FACC does not allege that the transactions contained a false appearance or other deceptive qualities, but rather that they were an opportunity for Homestore to take advantage of the advertising reseller agreement. This may pin liability on Homestore, but not on AOL or its officers.

The FACC also alleges that AOL attempted to include additional documentation in subsequent transactions that would connect the referral agreements between Homestore and the Third Party Vendors with the advertising revenues from AOL. While the absence of this additional documentation allowed Homestore to misreport the revenues from the AOL advertising referrals as stand-alone transactions, any misrepresentation in the transactions involving AOL resulted from the additional agreements between Homestore and the Third Party Vendors and the misreporting of the income by Homestore. The transactions involving AOL did not create a false appearance until they were viewed in conjunction with Homestore's actions before and after the transaction. While AOL would be liable under § 10(b) for its deceptive conduct as part of a scheme to defraud if AOL engaged in deceptive conduct, it may not be held liable for participating in legitimate transactions that became "deceptive" only when distorted by the willful or intentional fraud of another party. *See Parmalat,* 376 F.Supp.2d at 505 ("Any deceptiveness resulted from the manner in which Parmalat or its auditors described the transactions on Parmalat's balance sheets and elsewhere."). In this case, the FACC does not allege with the required

particularity that the transactions negotiated by Keller and performed by AOL created a false appearance.

We conclude that the FACC failed to sufficiently allege with particularity that AOL committed actions with the purpose and effect of creating a false appearance in furtherance of a scheme to defraud.

B. Primary Liability of Cendant and its officer Smith

The FACC also alleges that Cendant participated in a scheme to defraud by engaging in triangular transactions. Cendant argues that the transactions were simply "simultaneously agreed upon business transactions" and were not deceptive or manipulative absent the application of improper accounting principles by Homestore.

We agree that the FACC does not indicate how these transactions involving Cendant created a false appearance, independent from Homestore's misreporting of the income from these transactions as unrelated to any previous transaction. There are no allegations that show how the creation of the RETT and its funding by Cendant for future transactions with Homestore had the potential to misrepresent the reality behind the transactions.[7] In fact, the press release

7. In its opening brief, Plaintiff argues that Cendant took affirmative steps to conceal the true nature of the Move.com transaction. The paragraph in the complaint cited for this assertion only states that Cendant classified the $95 million funding of RETT as a "one time non-recurring expense." The FACC does not explain how this classification is false or a mischaracterization of the transaction.

from Cendant quoted in the FACC acknowledges that subsequent purchases by Cendant were planned in conjunction with Homestore's acquisition of Cendant's websites.

Although the creation of separate entities may indicate an attempt to conceal the source of funding for related transactions, *see Lernout,* 236 F.Supp.2d at 173, the FACC does not allege that Cendant's specific actions in these transactions created a false appearance independent of the improper accounting by Homestore. The FACC does not allege with particularity that Cendant acted with the purpose and effect of creating a false appearance of Homestore revenues with the aim of deceiving the investing public, and we conclude that the complaint was properly dismissed against Cendant and Smith.

C. Primary Liability of L90

The allegations involving L90 similarly fail to allege sufficiently that L90 used or employed a deceptive device by engaging in a fraudulent transaction as part of a scheme to defraud. There are no allegations that L90 helped to create or concoct this scheme, which allegedly followed the model set by AOL. As with AOL, there are no allegations that L90 acted with the purpose and effect of creating a false appearance in these transactions.

Mark Roah, an officer for L90, allegedly signed a false statement attesting to the fact that the transactions were not contingent on other related transactions, which may suffice to state a valid claim for primary liability under § 10(b).

The day after the false confirmation letter was signed by Roah, however, Homestore's CFO refused to sign the financial report based on the misstatements within the report. The information contained in the false confirmation letter by L90, or any other false statement which resulted from this confirmation letter, was never introduced into the securities market as part of a scheme to defraud. Therefore, this statement was never used or employed in connection with the purchase or sale of securities and the allegations concerning the statement cannot state a valid claim under § 10(b).

V

Because the FACC does not allege a valid claim for primary liability under any theory of liability, the district court properly dismissed the claims in the FACC against the Defendants. Dismissal without leave to amend is improper, however, unless it is clear that Plaintiff could not propose an amended complaint that states a valid claim under § 10(b) for any of these Defendants. *See Livid Holdings,* 416 F.3d at 946. "Leave to amend need not be granted when an amendment would be futile." *In re Vantive Corp. Sec. Litig.,* 283 F.3d 1079, 1097 (9th Cir.2002). Futility of amendment may be shown by Plaintiff's failure to plead additional facts when given the opportunity. *See id.* at 1098 ("When given the opportunity, the plaintiffs declined to say what additional facts they might plead if given the chance to amend."). Here, the district court applied a more restrictive test of primary liability than called for under § 10(b). Plaintiff was not offered the opportunity to state any additional facts that, if

alleged, would state a valid claim for relief under the standards we have set forth.[8]

We conclude that Plaintiff should have the opportunity to seek leave to file an amended complaint that may take advantage of the reasoning in this opinion. "In this technical and demanding corner of the law, the drafting of a cognizable complaint can be a matter of trial and error." *Eminence Capital, LLC v. Aspeon, Inc.*, 316 F.3d 1048, 1052 (9th Cir.2003). On remand to the district court, Plaintiff may argue to the district court that an amendment would not be futile based on the presence of additional relevant facts which it may plead. Defendants may argue any ground that they assert for denial of any proposed amendment. The district court

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8. Plaintiff raised the issue of amendment of the complaint in its briefing in the district court and on appeal. In the district court, Plaintiff argued in its opposition to Defendants' motions to dismiss that leave to amend should be granted if the district court found that the current complaint failed to state a valid claim. In its briefing to us, Plaintiff did not seek leave to amend until its reply brief. "We will not ordinarily consider matters on appeal that are not specifically and distinctly argued in appellant's opening brief." *United States v. Ullah*, 976 F.2d 509, 514 (9th Cir.1992) (internal quotation marks omitted). However, "we may review an issue if the failure to raise the issue properly did not prejudice the defense of the opposing party." *Id.* We determine that review of the issue of amendment does not prejudice the defense of the Defendants because we only remand the issue of amendment for the district court to assess in the first instance, after the parties have had an opportunity to address the standards for amendment and whether it is futile under the legal standard we have announced concerning the elements of § 10(b).

may then decide in the first instance whether any amended complaint may be filed.[9]

VI

We affirm the district court's dismissal of the current complaint against Defendants. We remand so that Plaintiff may seek leave in the district court to amend the complaint if that can be done consistent with this opinion. Costs are awarded to Defendants-Appellees.

AFFIRMED and REMANDED for further proceedings consistent with this opinion.

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9. If the district court decides to grant leave to amend, then the motion to dismiss filed by Defendant Smith must be resolved. Smith argues that he must be dismissed from any further litigation in this case because a Settlement Agreement between Plaintiff and Homestore released from liability all former officers and directors of Homestore, which included Smith. Plaintiff argues that Smith was excluded from this release because of his position with Cendant, which was the primary source of his alleged liability in this case. This issue will be moot if amendment is not permitted. Moreover, if necessary, the district court, which approved this Settlement Agreement, may interpret this Agreement and any admissible extrinsic evidence in the first instance. We leave this motion for consideration by the district court.

APPENDIX B — OPINION OF THE UNITED STATES DISTRICT COURT FOR THE CENTRAL DISTRICT OF CALIFORNIA DATED MARCH 7, 2003

UNITED STATES DISTRICT COURT
CENTRAL DISTRICT OF CALIFORNIA

No. C01-11115 MJP (CWx)

In re

HOMESTORE.COM, INC. SECURITIES LITIGATION.

March 7, 2003.

ORDER REGARDING MOTIONS TO DISMISS

PECHMAN, District Judge.

INTRODUCTION

This Complaint provides one explanation of how the now-infamous internet "bubble" occurred. Plaintiff in this putative class action is a shareholder in Homestore.com, Inc., ("Homestore") an internet-based company that provides links to a wide range of services related to home ownership, including real estate sales, home renovation, and relocation services. Plaintiff alleges in its complaint that several Homestore insiders, with the knowledge of Homestore's auditor and the active participation of various outside business entities, unlawfully created revenue through various types of dubious transactions in order to prop up Homestore's stock price. Plaintiff claims that these transactions, combined with improper accounting and the release of written and oral

public statements made to the SEC, analysts, and the general public, perpetrated a fraud on Homestore's shareholders and the investing public in violation of Federal securities statutes and regulations promulgated thereunder. Eventually, Homestore was forced to restate seven quarters of revenue because of the improper transactions and accounting. By this action, plaintiff seeks to recover damages incurred when the market price of Homestore common stock fell dramatically once the need for restatement became public.

This is a massive piece of litigation. In all, plaintiff has named twenty-eight (28) defendants who allegedly made misleading statements or omissions and/or participated in a scheme to defraud investors in contravention of federal securities laws. The Court notes from the outset that two other aspects set this case apart from most securities litigation reported in the case law. First, plaintiff makes allegations based on inside sources who were most probably former executives at Homestore and therefore provide a unique insight not generally available to most private securities litigants. Second, four former Homestore executives have pled guilty to various criminal charges involving securities fraud and insider trading. Thus, this case does not present the question of *whether* the fraud actually happened, but rather who *knew* about it, who *participated* in it, and who can be *held liable* for it.

Defendants Homestore.com and Peter Tafeen have opted to answer the complaint. All other defendants with the exception of Jeff Kalina and Top Producers Systems have filed motions to dismiss pursuant to Federal Rules of Civil Procedure 12(b)(6) and 9(b) and the Private Securities

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Litigation Reform Act ("PSLRA") of 1995, 15 U.S.C. § 78u. Having considered the voluminous pleadings and papers filed by the parties, and having heard oral argument on the issues, the Court rules as follows:

1) The motions of the following defendants are hereby DENIED: Stuart H. Wolff (Dkt. No. 126), Pricewaterhouse Coopers, (Dkt. No. 185);

2) The motions of the following defendants are GRANTED, and the complaint as to each defendant is DISMISSED WITHOUT PREJUDICE: David Rosenblatt (Dkt. No. 116), Allan Merrill (Dkt. No. 104), Catherine Kwong Giffen (Dkt. No. 204), Sophia Losh (Dkt. No. 117);

3) The motions of the following defendants are GRANTED, and the complaint as to each defendant is DISMISSED WITH PREJUDICE: AOL Time Warner (Dkt. No. 122), Eric Keller (Dkt. No. 203), David Colburn (Dkt. No. 111), Cendant Corporation (Dkt. No. 202), Richard Smith (Dkt. No. 202), L90 (Dkt. No. 205), Akonix (Dkt.Nos.108-109), CityRealty (Dkt. No. 108-113), Classmates Online (Dkt. No. 110), CornerHardware (Dkt. No. 108), Dorado Corporation (Dkt. No. 108), GlobeExplorer (Dkt. No. 100), Internet Pictures (Dkt. No. 108), PromiseMark (Dkt. No. 108), RevBox (Dkt. No. 108), SmartHome (Dkt. No. 108), and WizShop (Dkt. No. 153).

This order does not include or cover named defendants Privista, Inc, Top Producer Systems, Inc., or Jeff Kalina. Privista's Motion to Dismiss (Dkt. No. 209) was filed on February 24, 2003, and therefore will be noted for consideration on March 21, 2003, unless agreed otherwise by the parties.

Appendix B

BACKGROUND

A. *Factual Background*

Plaintiff makes the following factual allegations, which for purposes of this motion the Court must accept as true and construe in the light most favorable to the plaintiff. *No. 84 Employer-Teamster v. America West*, 320 F.3d 920, 930 (9th Cir.2003). The Court evaluates these allegations with the presumption that a complaint should not be dismissed "unless it appears beyond a doubt that the plaintiff cannot prove any set of facts in support of the claim that would entitle him or her to relief." *Id.*, *citing Williamson v. Gen. Dynamics Corp.*, 208 F.3d 1144, 1149 (9th Cir.2000). In this section, the Court gives a brief description of the parties, then an overview of the alleged illicit transactions that form the basis of the fraud, followed by a detailed factual recitation based on the plaintiff's allegations. Allegations specific to each defendant are analyzed separately below.

1. *The Parties*

Lead plaintiff California State Teachers' Retirement System ("CalSTRS"), a pension fund for California teachers, brings this putative class action against the defendants for damages arising from plaintiff's purchase of large amounts of Homestore common stock. These purchases were based on allegedly false or misleading financial statements filed with the SEC, as well as public comments made by the defendants.

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For convenience, the Court has grouped the defendants into four general categories: present and former executives of Homestore ("the Insiders"), business partners involved in arranging various "triangular" transactions ("the business partners"), the third party vendors who typically sold services or stock to Homestore and purchased Homestore advertising ("the third party vendors"), and the auditor Pricewaterhouse Coopers ("PWC"). Factual allegations as to each category are similar in some respects, but the Court must consider the allegations made as to *each* individual defendant when determining whether the requirements of Federal Rules of Civil Procedure 12(b)(6) and 9(b) and the PSLRA have been met.

a. *The Insider Defendants*

Insider defendants include Peter Tafeen, former Executive Vice President of Business Development and Sales; Stuart Wolff, former CEO and Chairman; David Rosenblatt, former Senior Vice President and General Counsel; Catherine Kwong Giffen, former Senior Vice President of Human Resources; Allan Merrill, current Executive Vice President of Corporate Development; Sophia Losh, former Senior Vice President of the Strategic Alliance Group ("SAG"); and Jeff Kalina, former Director of Transactions. Other major participants in the scheme include Joseph Shew, former Vice President of Finance and later CFO; John Giesecke, former CFO, and John DeSimione, former Director of Operations, Planning and Transactions in the Finance Department. These last four pled guilty to various criminal charges of corporate financing fraud and insider trading. The Complaint alleges that each and every one of

these inside defendants was motivated by personal profit to keep the price of Homestore stock high so that each could reap huge benefits from selling off vested and exercised stock options. Plaintiff alleges that these sales constituted illegal insider trading.

b. *The Business Partner Defendants*

There are three major players in the business partner category, with three individuals closely associated. Plaintiff alleges that America Online Time Warner ("AOL") was a major player in arranging many of the illicit revenue boosting transactions. AOL employees David Colburn and Eric Keller are also named as defendants for their roles as the primary Homestore contacts within AOL and the architects of many of the improper "round trip" transactions. Both were released by AOL under suspicion of certain illegal transactions with Homestore and other companies. Plaintiff does allege, however, that the transactions continued after the two individuals left, further implicating AOL in the scheme to defraud.

Cendant Corporation ("Cendant") is a major player in the on-line real estate business, and has substantial activities in the car rental and travel industries as well. Plaintiff alleges that Cendant and its CEO Richard Smith engaged in "triangular" transactions between Homestore, Cendant and one of Cendant's subsidiaries. This transaction also represents a "related party" transaction that was not appropriately accounted for as such.

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L90 is a media company. Plaintiff alleges that L90 engaged in illegal "triangular" transactions and "barter" transactions with Homestore and third parties.

c. *"Third Party Vendors"*

This is a catchall group of participants that is made up of smaller, thinly capitalized startup companies that allegedly engaged in illegal transactions with Homestore. They were either involved in barter transactions, "revenue purchasing" schemes, or made up the third leg of a "triangular" transaction, typically orchestrated through AOL.

d. *Pricewaterhouse Coopers*

PWC is a defendant in this action for its role in overseeing, approving and failing to properly audit the various transactions described below. Plaintiff alleges that PWC did not follow Generally Acceptable Auditing Standards and either tacitly approved and/or failed to reject several of the improper transactions and the accounting thereof.

2. *The Transactions*

There are basically three different but related types of transactions that are alleged to have taken place, all of which created "revenue" for Homestore through various ways that the transactions are "booked." These are the "barter transactions," "buying revenues" or "revenue purchasing," and the "triangular transactions." Below is a brief description of each one, though the complaint contains multiple descriptions of these accompanied by diagrams.

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"Barter transactions"—These are two-party reciprocal transactions. Plaintiff alleges that Homestore and other companies agreed to trade services, generally advertising for some amorphous service such as "web services" or "marketing solutions." Then, instead of just trading those services, the two companies agree to buy each other's services for an extremely exaggerated rate. For example, Homestore might pay $5 million for marketing solutions, and the other company pays $5 million for advertising. Homestore then realizes the $5 million in revenues. The problem is that in accounting for these transactions, Homestore is supposed to provide actual market value of the services, "net out" the cost of the reciprocal transaction (making the net revenue zero), and report the two transactions as linked. Homestore allegedly did not properly account for transactions on several occasions.

"Buying revenues"—These are two-party transactions as well, and are very similar to the barter transactions. The difference is that in this instance Homestore trades stock "warrants" (a form of stock option) for some service, and receives cash for some other service like advertising. The true transaction is the cash for the warrants, known as a "stock-for-revenue" transaction, which must be reported as such in accounting for the transactions. In addition, many of these transactions involved a guarantee by Homestore of a certain stock price by a specified date in the future—if the stock was not worth the amount guaranteed, Homestore was to be responsible for the difference. This is a safe transaction for the other company, but a very risky way of creating revenues for Homestore.

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"Triangular transactions," a.k.a. "round-tripping"—These are slightly more complex transactions involving three parties. The transactions allegedly arranged through defendant AOL provide good examples. AOL and Homestore entered into a "revenue sharing agreement" or "advertising reseller agreement" in which AOL agreed to sell advertising for Homestore for a commission. This commission was far above market value. This agreement may be valid on its own, but set the stage for allegedly illegal transactions. Homestore would find some third party corporation, one that was thinly capitalized and in search of revenues in order to "go public." Homestore then agreed to purchase shares in that company for inflated values or to purchase services or products that Homestore did not need. This transaction was contingent on the third party company "agreeing" to buy advertising from AOL for most or all of what Homestore was paying them. The money thus flowed through the third party to AOL, which then took a commission and shared "revenue" with Homestore. This is an exceptionally expensive way to create revenue due to the cuts taken in each step along the way. This practice depleted the cash reserves of Homestore, but created "revenue" in order to meet the revenue targets, resulting in an inflated stock price.

3. *Detailed Factual Recitation*

The First Amended Consolidated Complaint ("FACC") sets forth the following specific allegations regarding the improper transactions between Homestore and the other defendants:

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In 1996, Stuart Wolff founded "Realtor.com," the predecessor to Homestore, which listed real estate on the internet. FACC ¶ 88. Homestore was founded shortly thereafter, and eventually "went public" in 1999. *Id.* As with all internet companies of the 1990's, revenue growth was an important indicator of the financial well-being of the company. FACC ¶ ¶ 88, 109. Accordingly, there was enormous pressure on Homestore to show increasing revenues each quarter. FACC ¶ 109.

The relationship between Homestore and defendant AOL began in April of 1998, when Homestore purchased from AOL the exclusive right to have the only online real estate listing product on the AOL web site. FACC ¶ 113. Homestore purchased this exclusive right for $20 million in cash to be paid in installments as well as $1.5 million in Homestore warrants at various "strike prices." *Id.* Thus, when an AOL member sought real estate listings on the AOL website, that member would be directed to the Homestore.com website. FACC ¶ 114.

The inception of the defendants' scheme to deceive, manipulate and/or defraud the marked occurred in 1998 when Homestore entered into a series of improper "barter transactions" that formed the basis for transactions that were later restated. FACC ¶ 111. The Court notes, however, that the class period does not begin until the first quarter of fiscal year 2000 ("FYE 2000"), the first quarter in which Homestore was later required to restate its revenues. Therefore, these transactions predating the class period are not described in detail here, but merely provide a background for the alleged improper transactions made during the class period. First,

during the last half of fiscal year 1998 ("FYE 1998"), Homestore entered into reciprocal contracts constituting a barter transaction with RE/MAX International, Inc. FACC ¶ 118. Next, in the third quarter of fiscal year 1999 ("FYE 1999"), Homestore entered into reciprocal transactions with Wells Fargo Bank in which Homestore in essence traded 500,000 of its own warrants for $20 million in revenue. FACC ¶ ¶ 119-22. Then in the fourth quarter of FYE 1999, Homestore entered into similar reciprocal transactions with General Motors Acceptance Corporation ("GMAC") in essence trading 100,000 warrants at a specified strike price for another $20 million in revenue. FACC ¶ ¶ 126-28.

Meanwhile, in the first quarter of FYE 1999, Homestore entered into an advertising reseller agreement with AOL (hereinafter, the "second AOL agreement"). By this agreement, AOL would sell advertising on the Homestore website to third parties. FACC ¶ 124. AOL would retain a commission on the sale, and remit the remaining portion of the advertising revenue to Homestore. *Id.* AOL's commission was as high as 50% or more of the amount obtained from the third party company. FACC ¶ 337.

Plaintiff alleges that most of the improper transactions described below occurred near the end of the quarter when Homestore realized that the company might fall short of revenue targets set by Wolff and/or market analysts. They were one time, non-recurring deals, the purpose of which was to "fill the plug" or "make the bogie."

During the first three quarters of FYE 2000, Homestore entered into a series of "equity deals" that constituted

Homestore "buying revenues." FACC ¶ 139. In these transactions, Homestore would purchase stock of seemingly worthless companies. *Id.* In return, these companies agreed to purchase advertising on Homestore's website, using the money obtained in the stock sale. *Id.*. These companies included defendants Dorado Corporation ("Dorado"), CornerHardware.com ("CornerHardware"), RevBox, Inc. ("RevBox"), and SmartHome, Inc. ("SmartHome"), as well as non-defendants Investor Plus, and OnlineChoice.com, Inc. FACC ¶ 140. Homestore then booked its recycled money as revenue. FACC ¶ 142. Meanwhile, PWC reviewed each of these "investment and distribution" deals, which in total resulted in approximately $40 million in revenues recognized by Homestore. FACC ¶ 147. There was much debate between PWC and Homestore executives regarding whether these transactions should be reported as gross revenues, or if they should be "netted out" against each other. *Id.* PWC allowed these transactions to be reported as gross, but later forced Homestore to report nearly identical transactions as net. *Id.*

Throughout FYE 2000, Homestore entered into several other reciprocal, round trip transactions with third party vendors, including defendants CityRealty.com, Inc. ("CityRealty"), Classmates Online, Inc. ("Classmates"), PromiseMark, Inc. ("PromiseMark"), Privista, Inc. ("Privista") and Akonix Systems, Inc. ("Akonix"), as well as non-defendant iPlace. FACC ¶¶ 148-50. In the first leg of each transaction, Homestore would pay cash to the third party vendor in exchange for advertising or other services. FACC ¶ 151. In the second or reciprocal component of the transaction, the third party vendor would recycle that cash in a nearly identical amount to Homestore in exchange for

advertising or other services. *Id.* PWC had knowledge of the details of each of these transactions, and began to question their round trip nature in late 2000. FACC ¶ 152. PWC required the "netting" of some, but not all, of these transactions, including the CityRealty transaction in the first quarter of 2001. *Id.*

In May of 2000, Homestore and AOL entered yet another agreement (hereinafter the "third AOL agreement"). The agreement established Homestore as the exclusive distributor of home-buying and moving services across AOL properties. FACC ¶ 154. The agreement also required AOL to establish the "House & Home" channel on its website for which Homestore would be the exclusive content provider, and included a revenue sharing agreement to share revenue generated from the traffic on that channel. *Id.* In return, AOL would obtain 3.9 million shares of Homestore stock at the guaranteed price of $68.50 per share, as well as $20 million in cash. *Id.* AOL would also receive a $90 million letter of credit that it could use if Homestore's stock did not meet the guaranteed price. *Id.* The agreement received a great deal of news coverage, and analysts predicted that Homestore would exceed the guaranteed strike price. FACC ¶ 155-56. Plaintiff alleges that this transaction was improper because it constituted a "stock-for-revenue" transaction. FACC ¶ 158.

During the fourth quarter of FYE 2000, Homestore entered into another "stock-for-revenue" transaction, this time with Bank of America. FACC ¶ 159. The agreement involved the exchange of 600,000 unregistered shares of Homestore stock, advertising, and website services for $4.5 million in cash, with $15 million to follow, and "marketing

solutions" for MyHomeSolutions.com. *Id.* PWC reviewed and approved this transaction, which was one of the transactions for which revenue was later restated. FACC ¶ 161.

In late 2000, Homestore announced that it would acquire Cendant Corporation's online real estate web site, Move.com. FACC ¶ 166. Homestore and Cendant completed this acquisition through a complex multi-legged transaction. First, Homestore gave Cendant 21.4 million shares of Homestore stock (a 20% share) worth approximately $750 million as payment for 100% of the stock in Move.com and another Cendant subsidiary, Welcome Wagon. FACC ¶ 167-68. Cendant's acquisition of a 20% share of Homestore allowed it to elect two seats on the Homestore board, one of which was occupied by defendant Richard Smith. FACC ¶ 169. Second, Cendant funded the Real Estate Technology Trust ("RETT") with $95 million. FACC ¶ 167. Third, RETT paid Homestore $80 million for certain commercial products and services. *Id.* These three transactions were simultaneous and contingent upon one another, and were considered "related party" transactions. FACC ¶ 170. PWC was "concerned" about the reciprocal nature of the transaction, and involved its national office in the accounting. *Id.*

Meanwhile, RETT was left with $15 million remaining in cash. During the first quarter of FYE 2001, Homestore had acquired Internet Pictures Corporation ("iPix"). FACC ¶ 141. When Homestore needed revenues, its executives arranged through Cendant for RETT to purchase $15 million worth of "virtual tours" of houses. FACC ¶ 172. Homestore in turn agreed to give back the money through the purchase

of $15 million in products from Cendant. *Id.* Defendant Tafeen allegedly signed a contract evidencing the return of the money, but hid it so that PWC would not discover the reciprocal nature of the transactions. FACC ¶ 385.

During the first quarter of FYE 2001, Homestore entered into a series of illegal triangular transactions with third party vendors, resulting in "revenue" for Homestore. FACC ¶ 174. These transactions involved third party vendor defendants Classmates and Wizshop, as well as non-defendants PurchasePro, InvestorPlus, EasyRoommates, and FX Consultants. FACC ¶ 176. First, Homestore would buy a product from a third party vendor on the condition that the third party vendor would purchase Homestore advertising from AOL. FACC ¶ 175. AOL would then take a commission and round trip Homestore's own money back to it under the reseller agreement. *Id.* The parties all agreed that AOL would not document the agreement by the third parties to purchase advertising from AOL. FACC ¶ 177. These transactions allowed Homestore to realize approximately $15 million in "revenue." FACC ¶ 176.

During the second quarter of FYE 2001, Homestore entered into a modified triangular transaction with InvestorPlus, a subsidiary of "IPG". FACC ¶ 178. Homestore had an accounts receivable with IPG totalling $5 or $6 million dollars from a previous transaction. *Id.* Now, Homestore agreed to forgive that debt in exchange for a website valued at $6 million, and IPG agreed to purchase advertising from AOL. FACC ¶ 179. Homestore's money was then returned to it pursuant to the advertising reseller agreement. *Id.* The agreement to purchase advertising from AOL was not reported as related to the agreement to forgive the accounts receivable. FACC ¶ 181.

During that same quarter, Homestore entered into a round trip transaction in acquiring "Homestyles," a subsidiary of Buildnet. FACC ¶ 182-83. This transaction was negotiated and orchestrated by defendant Allan Merrill. FACC ¶ 182. In this set of transactions, Homestore paid Buildnet $23 million in cash to acquire Homestyles. FACC ¶ 183. Buildnet then paid between $5 and $6 million to AOL for Homestore advertising. *Id.* Some of this money was then round tripped back to Homestore, and was recognized as revenue. FACC ¶ 184.

During the second and third quarters of FYE 2001, Homestore entered into triangular transactions with defendant L90 that were similar to those involving AOL. FACC ¶ 185. In these transactions, Homestore paid cash to a third party vendor such as "Hi-Speed Media" in exchange for purported goods and/or services. *Id.* That company then used that money to pay L90 for purported goods and/or services. *Id.* Finally, L90 recycled the money back to Homestore for advertising, which would be recognized as revenue. *Id.*

The FACC also details a great number of press releases, analyst reports, news articles, and SEC filings that relate to or are based upon the above-described transactions. *See* FACC ¶¶ 186-195. The FACC also independently pleads scienter for each of the defendants. *Id.* pp. 103-238. For the sake of brevity, the Court will not discuss those allegations in detail here, but rather will reference those that are pertinent when analyzing the allegations as to each defendant.

Appendix B

B. *Legal Background*

Congress enacted the Securities Exchange Act of 1934 to regulate various practices of trading in securities in an effort to correct many of the abuses that led to the stock market crash of 1929. Plaintiffs in this case have brought causes of action under Sections 10(b) and 20(a) of the Act, as well as under the Security and Exchange Commission's ("SEC") Rule 10b-5, which implements § 10(b) of the Act. Section 10(b) of the Act states in relevant part:

> It shall be unlawful for any person, directly or indirectly . . . (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may proscribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b). Rule 10b-5 implements this statute, stating:It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in

> order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice or course of business which operated or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5. Section 20(a) of the Act confers liability on those who direct others to commit violations of the Act: 1) Joint and Several liability; good faith defense

> Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

15 U.S.C. § 78t(a). Therefore, in order to allege a violation of § 20(a), plaintiff must establish a strong inference of (1) a primary violation of federal securities laws; and (2) that the defendant exercised actual power or control over the primary violator. *Howard v. Everex Systems, Inc.*, 228 F.3d 1057, 1065 (9th Cir.2000).

Appendix B

1. *The Private Securities Litigation Reform Act of 1995*

In 1995, Congress enacted the Private Securities Litigation Reform Act, 15 U.S.C. § 78u, over a presidential veto. By this legislation, Congress "sought to reduce the volume of abusive federal securities litigation by erecting procedural barriers to fraud claims." *In re Silicon Graphics, Inc. Securities Litigation*, 183 F.3d 970, 977 (9th Cir.1999). Put another way, the PSLRA was intended "to put an end to the practice of pleading 'fraud by hindsight,' " by which investors allege fraud by questioning past corporate decisions once a company's stock price has dropped. *Id. at 988.* In relevant part, the PSLRA states:

> (b) Requirements for securities fraud actions
>
> 1. Misleading statements and omissions
>
> In any private action arising under this chapter in which the plaintiff alleges that the defendant—
>
> (A) made an untrue statement of a material fact; or
>
> (B) omitted to state a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading;

> the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.
>
> 2. Required state of mind
>
> In any private action arising under this chapter in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.

15 U.S.C. § 78u-4(b)(1) and (2). The state of mind requirement is known as the "scienter" requirement. With respect to "forward-looking" statements, the PSLRA requires that the plaintiff plead and prove that the person making the statement had "actual knowledge" of its falsity or misleading character at the time the statement was made. 15 U.S.C. § 78u-5. This last requirement is designed to prevent insiders from being liable for mere "puffery" or corporate optimism.

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As with any litigant alleging fraud, the PSLRA plaintiff must plead with particularity all facts demonstrating that a specific defendant made a statement or committed an act or was involved in a scheme that was false or misleading. But the PSLRA goes beyond the requirements of Rule 9(b) and requires that the securities fraud plaintiff must plead facts demonstrating *why* the statement, act or scheme is misleading. Thus, not only does the PSLRA require that both falsity and scienter to be pled with specificity, it requires that the facts pled must give rise to a "strong inference" that each defendant acted with the requisite state of mind. But what is that state of mind? And what is a "strong inference"? Finally, how much specificity is enough? These are the questions that courts have struggled with since the passage of the PSLRA.

The Ninth Circuit first squarely addressed the issue of scienter under the PSLRA in *In re Silicon Graphics, Inc. Securities Litig.*, 183 F.3d 970 (9th Cir.1999). There, the court held that a plaintiff "must plead, in great detail, facts that constitute strong circumstantial evidence of deliberately reckless or conscious misconduct." *Id.* at 974. Specifically, the court stated:

> We hold that although facts showing mere recklessness or a motive to commit fraud and opportunity to do so may provide some reasonable inference of intent, they are not sufficient to establish a *strong* inference of deliberate recklessness. In order to show a strong inference of deliberate recklessness, plaintiffs must state

> facts that come closer to demonstrating intent, as opposed to mere motive and opportunity.

Id. (emphasis in original). The court therefore seems to have converted what was a standard of "an extreme departure from the standards of ordinary care," which is the definition of recklessness, to one that approaches the standard for "intent." *Id.* at 976.

Because the facts that support inferences of falsity and scienter are almost always the same, the Ninth Circuit has collapsed the elements into a single inquiry: "whether the particular facts in the complaint, taken as a whole, raise a strong inference that defendants intentionally or [with] deliberate recklessness made false or misleading statements." *Ronconi v. Larkin*, 253 F.3d 423, 429 (9th Cir.2001). Alternatively, a complaint may allege facts giving rise to a strong inference of intentional misconduct or deliberate recklessness in the participation in a scheme or deceptive device to defraud investors. *No. 84 Employer-Teamster v. America West*, 320 F.3d at 937 (holding that controlling shareholders could be held liable for insider trading, which qualifies as a deceptive device).

2. *Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164 (1994), and the Bar on Aider and Abettor Liability*

Each of the outside defendants argues strenuously that they cannot be held liable under § 10(b) and Rule 10b-5 as a result of the Supreme Court's decision in *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 114

S.Ct. 1439, 128 L.Ed.2d 119 (1994), holding that the Securities Exchange Act and the rules promulgated thereunder did not provide for aider and abettor liability. In that case, a public housing authority issued a series of bonds to finance public improvements. *Id.* at 167, 114 S.Ct. 1439. The bonds were secured by land under a covenant that required that the land be valued at 160% of the value of the bond. *Id.* A question arose as to the actual value of the land that secured these particular bonds, which were held by indenture trustee Central Bank. *Id.* Land values were decreasing at the time, and a Central Bank underwriter expressed concern that the 160% requirement was not being met. *Id.* Central Bank was going to order an independent review, but the housing authority convinced it to hold off for 6 months. *Id.* at 168, 114 S.Ct. 1439. In the meantime, the authority defaulted on the bonds. *Id.* Central Bank was sued for its acquiescence as an aider and abettor of the primary violators, who included the authority and the underwriters. *Id.*

In reversing the Court of Appeals, the Supreme Court analyzed the text and legislative history of the Securities and Exchange Act and determined that only primary violators of the Act could be held liable for fraudulent acts or misleading statements or omissions. The statute itself provided for no secondary aider and abettor liability.

Each of the seventeen "outside" defendants defined above as "business partners" and "third party vendors" has asserted that even if all allegations concerning their participation in Homestore's fraudulent acts are true, which for purposes of this motion this Court must assume, they cannot be held liable because their actions constitute mere "aiding and abetting."

Appendix B

3. *Liability of the Auditor Pricewaterhouse Coopers*

A plaintiff alleging a violation of Section 10(b) and Rule 10b-5 against an independent auditor such as PWC must satisfy the requirements of the PSLRA by alleging with specificity that "the accounting practices were so deficient that the audit amounted to no audit at all, or an egregious refusal to see the obvious, or to investigate the doubtful, or that the accounting judgments which were made were such that no reasonable accountant would have made the same decisions if confronted with the same facts." *DSAM Global*, 288 F.3d at 390; *citing In re Worlds of Wonder Secs. Litig.*, 35 F.3d 1407, 1426-27 (9th Cir.1994).

ANALYSIS

In determining the sufficiency of the FACC, the Court applies the above-stated legal standards to the facts alleged as to each defendant. For the insider defendants, the Court simply ascertains whether the pleading requirements of the PSLRA have been met. As for the business partner and third party vendor defendants, the Court holds that the Supreme Court's decision in *Central Bank* precludes liability from being asserted against these aiding and abetting defendants as a matter of law. Therefore, no analysis of sufficiency of the Complaint is required. Finally, the Court determines whether the FACC alleges sufficient facts as to PWC in light of the PSLRA and the case law setting the standards for auditor liability.

Appendix B

A. *The Insider Defendants*

The Court must determine whether the facts alleged as to each of the insider defendants raises the required "strong inference" of intentional misconduct or "deliberate recklessness" as to the relevant false or misleading statements, acts, or scheme. *In re Silicon Graphics*, 183 F.3d at 974; *No. 84 Employer-Teamster v. America West*, 320 F.3d at 937.

From the outset, two legal issues must be resolved. First, the Court must address plaintiff's allegations regarding the insider defendants' stock sales. Second, the Court addresses plaintiff's reliance on the "group published" doctrine in its attempt to assign many of the inside defendants.

In support of its allegations of scienter, plaintiff claims that each of the inside defendants' sales of Homestore stock were unusual or suspicious and constituted insider trading. Unusual or suspicious stock sales may be circumstantial evidence of scienter, but only when the sales are "dramatically out of line with prior trading practices at times calculated to maximize the personal benefit from undisclosed inside information." *In re Apple Computer Secs. Litig.*, 886 F.2d 1109, 1117 (9th Cir.1989). A non-exclusive list of factors to consider includes: 1) the amount and percentage of shares sold by the insider, 2) the timing of the shares, and 3) whether the sales were consistent with the insider's prior trading history. *Silicon Graphics*, 183 F.3d at 986.

In this case, two trading restrictions affected these factors. First, there was a 180-day window after the IPO of

Homestore.com during which insiders were not allowed to sell shares. Second, the insiders had a 30-day (approximate) window in which to sell shares each quarter. This window began 3 days after each quarterly filing and ended 30 days prior to the start of the next quarter. The Court finds that none of the stock sales histories of any of the insider defendants is properly pled to support an inference of scienter. First, plaintiff does not provide the percentage of holdings sold in each of the transactions. The Court finds this to be a key piece of information in deciding whether stock sales support an inference of deliberate recklessness as to any fraudulent statement, act, or scheme. Second, the timing of the sales is not suspicious. The insider defendants were restricted to a specific trading window during which they could sell stock—that window occurs *after* the release of public financial statements. This restriction is presumably in place in order to keep insiders from dumping their stock just prior to the release of adverse information. The trading window also explains why the insider defendants had common trading days. The timing is simply not suspicious. Third, there is no showing that sales made within the class period were somehow inconsistent with the insiders' trading histories. In many cases, no trading history was available, since the insiders were restricted from trading within the 180 days after the company went public. Because the Court finds that none of the insiders' stock sales were unusual or suspicious, these allegations will not be considered in the individual analyses below.

Next, the Court analyzes the viability of the "group published doctrine" after the enactment of the PSLRA. Prior to the enactment of the Reform Act, this doctrine allowed

for a presumption that false and misleading information conveyed in documents, including press releases, are made by the collective action of the officers of a corporation. *In re GlenFed, Inc.*, 60 F.3d 591, 593 (9th Cir.1995). Yet even then, the doctrine applied only to defendants who either "participated in the day-to-day corporate activities or had a special relationship with the corporation, such as participation in preparing and communicating group information at particular times." *Id.*

Since the enactment of the PSLRA, district courts in this circuit have struggled with the doctrine's continued viability in light of the PSLRA's stringent pleading requirement regarding scienter. Of the courts that have heard the issue, some have continued to recognize the continued viability of the group published doctrine despite the enactment of the PSLRA. *In re Secure Computing Corp. Secs. Litig.*, 120 F.Supp.2d 810, 821-22 (N.D.Cal.2000) (applying doctrine to officers and members of executive committee after enactment of PSLRA); *In re Stratosphere Corp. Sec. Litig.*, 1 F.Supp.2d 1096, 1108 (D.Nev.1998) (holding that PSLRA did not abolish doctrine, and applying it to those with high level positions within a company); *but see Allison v. Brooktree Corp.*, 999 F.Supp. 1342, 1350 (C.D.Cal.1998) (doctrine's continued vitality suspect where the PSLRA refers specifically to pleading specific facts as to the misleading statements of *the defendant*, not a group of defendants, and where it is not reasonable to presume that in every case every officer joined in the scheme to fraud investors).

For purposes of the present case, this Court holds that, at a minimum, plaintiffs must explain the nature of the

misrepresentation in the published statement, and establish that the defendants were involved in the day-to-day management of those parts of the corporation involved in the alleged fraud. *Pegasus Holdings v. Veterinary Ctrs. of America, Inc.*, 38 F.Supp.2d 1158, 1166 (C.D.Cal.1998). Furthermore, "with regard to allegations concerning the liability of the individual defendants for 'group published' information, plaintiffs must indicate the statements that they contend fall under the doctrine." *In re Autodesk, Inc. Secs. Litig.*, 132 F.Supp.2d 833, 846 (N.D.Cal.2000).

1. *Homestore.com and Peter Tafeen*

The Court simply notes that defendants Homestore.com and its former Executive Vice President of Business Development and Sales Peter Tafeen have opted to answer the complaint rather than file motions to dismiss.

2. *Stuart Wolff*

Defendant Wolff moves to dismiss the FACC on the ground that the facts alleged as to him do not establish deliberate recklessness as to any of Homestore's fraud. Mr. Wolff primarily argues 1) that the FACC does not support a strong inference that he knew of improper accounting; 2) that allegations regarding his stock sales do not support a strong inference of scienter; and 3) that his statements of general corporate optimism and forward looking statements are immaterial and/or insufficient to state a claim. The Court disagrees, and finds that the factual allegations in the FACC, when considered cumulatively and in context, are sufficient to support a "strong inference" of deliberate recklessness.

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First, the Complaint provides important background information giving insight into defendant Wolff's state of mind. Wolff was the CEO, Chairman and co-founder of Homestore. Plaintiff alleges that he was a controlling manager with a hands-on managerial style, and thus was in a position to know how revenue was being recognized. FACC ¶ 437. He was obsessed with the "revenue growth rates" at the company, and set unrealistically high revenue targets each quarter because he wanted to compete with major internet companies. FACC ¶¶ 328, 439, 585, 601. Plaintiff alleges that Wolff's obsession with hitting revenue targets, combined with his concern for selling his own stock, set the stage for the illegal revenue recognition that eventually took place. FACC ¶ 578. These allegations, standing alone, support no inference of deliberate recklessness. However, they provide important background information by which to assess other alleged facts.

Plaintiff also alleges that defendant Wolff received and understood internal reports that document the fraud. Specifically, plaintiff alleges that Wolff received and understood the periodic "Risk and Opportunity" ("R & O") schedules circulated to senior management. FACC ¶ 328 and Ex. E. The purpose of these schedules was to evaluate the quality of anticipated revenues for the quarter, and to determine what the shortfall would be for hitting the quarterly revenue targets. *Id.* Plaintiff alleges that senior management understood that "good quality" revenues frequently would not materialize, and that the company would have to scramble in the last few days of the quarter to make the "plug" or "bogie." *Id.* Additionally, separate schedules were created to assess the costs involved in the triangular deal done with

AOL in the first quarter of FYE 2001. FACC ¶ 348. Wolff himself presented a schedule depicting the triangular nature of the AOL deals. *Id.* All those who received these schedules also understood that they depicted the cost of "buying revenue," as detailed in line items such as "SAG carry-over costs," and knew that these amounts would not be coming back to Homestore because of the commission taken by AOL. FACC ¶ 338, 348.

Next, plaintiff alleges that Wolff was intimately involved with statements to analysts, investors, and the public. FACC ¶ 437. For example, in conjunction with an October 19, 2000, press release, defendant Wolff was quoted as saying, "This quarter we joined an elite group of Internet companies that have achieved cash profitability," touting the company's *past* successes. FACC ¶ 214. This statement is neither forward looking, nor mere "puffery." This is a definitive statement about a specific aspect of the company's financial health, and was made while Mr. Wolff was in possession of non-public information that would prove his statements false. That knowledge is proven by Mr. Wolff's possession and understanding of the R & O sheets and the end of the quarter deals that were made simply to meet or beat the revenue targets.

Plaintiff alleges that Wolff was also obsessed with increasing the value of Homestore common stock in order to sell his own personal holdings at the highest possible value. FACC ¶ 444. Wolff also apparently instructed other Homestore insiders as to volume and timing of stock sales so as not to alarm Wall Street. FACC ¶¶ 456, 458, 469, 511, 518. He personally sold 693,600 shares for proceeds of

$13,763,389.75. FACC ¶ 429. While the sales of stock themselves do not support an inference of scienter as "dramatically out of line" with his prior trading history, *In re Apple Computer, 886 F.2d at 1117*, the fact that he instructed others in how to sell off holdings without raising suspicions, a fact this Court must accept as true, supports an inference that Mr. Wolff was trading on non-public information, yet trying to avoid detection. This fact goes directly to defendant Wolff's culpable state of mind and supports a finding of scienter.

Wolff was involved in the negotiation and orchestration of many of Homestore's illicit revenue transactions. Specifically, plaintiff alleges that Wolff knew of the improprieties of the triangular transactions with AOL, and knew that Homestore did not document the "hidden" third leg of these transactions in which third party vendors purchased Homestore advertising from AOL. FACC ¶ 335. Again, Wolff attended meetings in which accounting schedules were circulated that clearly depicted the cost of the triangular deals. FACC ¶ 338. Wolff told Shew that he did not like the AOL deals, but rationalized them as a one-time occurrence that would be covered up by the potential AOL merger or an upswing in the economy. FACC ¶ 344.

Perhaps the most revealing allegations tending to show defendant Wolff's scienter are those of the "pre-meeting" at the Cal Amigos Ranch Retreat, which took place on May 7, 2001. FACC ¶ 349. The FACC describes a meeting that included Wolff, Tafeen, Shew and Giesecke, the entire focus of which was how to buy revenues. The current R & O schedule was discussed, which depicted an impending

revenue shortfall of $40-50 million. FACC ¶ 350. Wolff and Tafeen both asked if there were any other sources of "good revenues." *Id.* Tafeen suggested that they try another Cendant or AOL barter deal. *Id.* At one point, Wolff wondered out loud: "where do we get the revenue?" *Id.* While brainstorming about how to come up with the "plug," Shew explained to everyone that as a result of "raising the guidance" and the fact that only net revenues could be booked, a much larger amount would be needed. FACC ¶ 351. The four discussed a deal with Cendant, and while both Shew and Giesecke acknowledged that a Cendant deal could happen, they reiterated that the "back end" could not be documented. FACC ¶ 351. Thus, this small group of executives plotted a scheme to create revenues to make the target, and discussed how to manipulate the documentation in order to avoid detection by PWC. The description of this pre-meeting leaves little room for interpretation. The Court finds that the very detailed allegations concerning this meeting raise a strong inference of at least deliberate recklessness regarding a scheme to defraud Homestore's shareholders and the investing public. Plaintiff has alleged that it was explained to Wolff in no uncertain terms that certain aspects of certain transactions could not be disclosed to Homestore's own auditor. The FACC thereby alleges sufficiently specific facts that tend to support a strong inference of intentional misconduct or at the very least deliberate recklessness.

The Court also notes that defendant Wolff signed each and every one of the SEC-mandated financial reports on behalf of Homestore. FACC ¶ 437. Wolff tries to argue that this doesn't mean that he understood what he was signing or

that he in any meaningful way participated in their fraudulent nature or content. The Court finds this argument hard to accept in the context of the other allegations contained in the Complaint. "Key corporate officers should not be allowed to make important false statements knowingly or recklessly, yet still shield themselves from liability to investors simply by failing to be involved in the preparation of those statements." *Howard v. Everex*, 228 F.3d 1057, 1062 (9th Cir.2000). While a signature alone may not be enough to establish liability, the signing of Homestore's filing does establish that Mr. Wolff made "statements" within the meaning of the act and the rule. Plaintiff has independently alleged Wolff's scienter as to the falsity or misleading nature of those statements.

Even in the face of these specific factual allegations, Mr. Wolff claims that nothing in the complaint alleges that he knew that improper accounting was going on. Mot. at 7. Even if "actual knowledge" were the standard instead of "deliberate recklessness," this claim of innocence falls flat. Lest there be any doubt as to the sufficiency of allegations about Mr. Wolff's scienter as to accounting practices, the Court cites at length from paragraph 359 of the Complaint:

> 359. On June 29, 2001, the last day of the second quarter, AOL had yet to receive confirming letters from a number of the third party vendors about placing the required advertising. AOL was taking the position that it could not agree to pay Homestore until the letters were received. . . . Ripp called back late in the evening on the 29th, and Wolff gathered Shew for the call who then

told Giesecke that AOL was on the line and that AOL had not yet authorized most of the deal. Wolff, Tafeen and Shew got on the line and at some point Giesecke came in as well . . . **DeSimone, Kalina and Tafeen put a schedule together for Wolff so that he could address the details of the deal.** Wolff emphasized that the deal had been agreed to long ago by Keller, and he threatened litigation. Ripp and Rindner said that Keller was gone, but never denied Keller's authority to do the deal or that he had done the deal. Wolff responded that Keller was the authorized agent acting for AOL when he cut the deal, and suggested if there was any doubt about it, they should get Keller on the line. Tafeen said he had just talked to him and knew how to get a hold of him, but the AOL representatives declined the offer. There was a discussion about the size of the deal, the revenue recognition problems from AOL's end, and whether the Homestyles deal should be included. Shew then addressed the fact that he had already confirmed that money had already gone to certain of the third party vendors and AOL had received the payments for the advertising. **The manner in which Shew explained how the money flowed left no doubt about the "round trip" nature of the subject transaction**, and neither Rindner nor Ripp denied knowledge of the structure as described by Shew. **Essentially, Shew told Rindner and Ripp in no uncertain terms that Homestore had fronted the money to the third party vendors** in order

> to solve AOL's revenue recognition issues, that Homestore knew AOL had received the money, and based on the way the deal was structured, AOL had no reason not to pay Homestore and complete the deal.
>
> 360. AOL sent in their confirmation of the deal that evening after the call ... If Wolff didn't already understand the nature of the deals, he had it explained to him "in no uncertain terms" during the June 29, 2001, telephone conference call.

Plaintiff makes numerous other allegations regarding Mr. Wolff that the Court will not detail here. The facts outlined above are sufficient to satisfy the stringent pleading requirements of the PSLRA. Relying on background contextual information, internal reports at Homestore, public statements made by Wolff, his personal involvement in deals that were later restated, as well as specific, detailed allegations regarding personal behind-the-scenes conversations, the plaintiff adequately puts forth facts that give rise to a strong inference of deliberate recklessness, if not intentional misconduct, on the part of defendant Wolff. In addition, because the plaintiff has alleged a primary violation of § 10(b), and because Mr. Wolff was a "control person" within the meaning of § 20(a), plaintiff has stated a claim under § 20(a). Wolff's motion to dismiss is therefore DENIED.

Appendix B

3. *David Rosenblatt*

Defendant Rosenblatt moves to dismiss the FACC on the ground that the facts alleged as to him do not establish deliberate recklessness as to any of Homestore's fraud. Mr. Rosenblatt principally argues that the FACC does not attribute any of the false or misleading statements to him, that the FACC does not allege sufficient facts establishing his knowledge of improper accounting practices, and that scienter cannot be inferred simply from his position within the company and his stock sales. The Court agrees, and the Complaint as to David Rosenblatt is DISMISSED WITHOUT PREJUDICE.

Plaintiff's allegations as to Mr. Rosenblatt are very thin and all too often conclusory. Plaintiff first relies on Mr. Rosenblatt's position as General Counsel of Homestore, stating that as such, he "played a key role in drafting and/or approving Homestore's public filings and was instrumental in developing and implementing the revenue deals which are the subject of the complaint." FACC ¶ 39. This statement itself is non-specific, and never appears to have been properly corroborated in the other allegations in the complaint.

Plaintiff also alleges that Rosenblatt "executed his 'own deals.' " FACC ¶ 462. Yet the only "deals" that are tied directly to Rosenblatt are the "Marriott" and "Champion Enterprises" deals, FACC ¶ ¶ 462, 463, neither of which is alleged to have been improper.

All other allegations as to Mr. Rosenblatt are similarly conclusory or non-specific—that he "was aware of and

participated in the scheme to defraud," FACC ¶ 459, that he "participated in the negotiations and documentation of Homestore's transactions," FACC ¶ 460, and that he "had an opportunity to see all legs of the transactions and knew that they were bogus." *Id.* Without more, these allegations do not achieve the requisite level of specificity as to the alleged wrongdoing.

Plaintiff's reliance on the group published doctrine with respect to Rosenblatt does not save it. Plaintiff has not pled with any specificity the nature of Mr. Rosenblatt's "participation in day-to-day activities" or that he had the requisite special relationship with the company. Being close to Tafeen and Wolff simply is not enough. Furthermore, plaintiff has not indicated which deceptive or misleading statements or acts fall within the doctrine.

Taken on the whole and in context, the allegations contained in the FACC are insufficient to establish the "strong inference" of deliberate recklessness as to any statement, act or scheme on Rosenblatt's part. Likewise, because no primary violation has been shown, and because plaintiff did not state in the FACC the primary violators over which Rosenblatt had "control," the FACC is insufficient to establish a claim for control person liability under § 20(a). Nevertheless, the Court finds that the most prudent course of action is to allow leave to amend, as the allegations against Mr. Rosenblatt, if properly supported in sufficient detail, would state a claim upon which relief could be granted. *Eminence Capital v. Aspeon, Inc.*, 316 F.3d 1048, 1052 (9th Cir.2003) (dismissal without leave to amend not appropriate unless clear that pleading could not be saved by amendment). Therefore, the FACC is DISMISSED WITHOUT PREJUDICE as to defendant Rosenblatt.

Appendix B

4. *Allan Merrill*

Defendant Allan Merrill moves to dismiss the Complaint on the ground that it does not plead sufficient factual allegations to support the required "strong inference" of deliberate recklessness of a false or misleading statement, act or scheme. The Court agrees, and the FACC is DISMISSED WITHOUT PREJUDICE as to him.

Plaintiff's allegations of securities fraud as to Mr. Merrill basically come down to his participation in one transaction involving the acquisition of "Homestyles." According to plaintiff's sources, Merrill was the "architect" of the $23 million deal. FACC ¶ 474. Plaintiff alleges that the deal was presented to Homestore's board of directors as a $15 million deal, but was later recorded in the minutes as a $23 million deal. *Id.* Plaintiff's sources believe that the board minutes were forged and that the remaining $8 million was used as part of a round trip transaction with AOL. *Id.* But plaintiff does not provide any corroborating details in support of this belief. Furthermore, there are no allegations to support the inference that Merrill acted with scienter when he negotiated and orchestrated the Homestyles deal.

All other allegations made as to Merrill do not tend to support an inference of deliberate recklessness, and often support the contrary inference. The Court first notes that Merrill only became a Homestore insider at the tail end of the Class Period, and is still an officer of Homestore. Next, plaintiff's allegations regarding the L90 triangular deal do not support a strong inference of scienter. Merrill was apparently peripherally involved in what appears to be an

attempt at extortion by Mark Roah of L90. FACC ¶¶ 389-97. Roah allegedly tried to get Homestore to pay him $50-100,000 to provide confirmation of the deal consummated during the second and third quarters of FYE 2001. FACC ¶¶ 395-96. "Merrill told Shew that Homestore would not pay." FACC ¶ 395. If anything, this shows Merrill attempting to follow securities laws, not break them.

Other allegations regarding: 1) Merrill's role in the preparation and filing of Homestore's third quarter FYE 2001 financial statement, 2) Merrill's role in the "spin" on the company's downfall, and 3) Merrill's inability to formulate a response to an audit committee member's question about Homestore's accounting practices, all fail either for lack of specificity or because they simply do not support an inference of deliberate recklessness with respect to any allegedly false or misleading statement, act or scheme.

Plaintiff's reliance on the group published doctrine does not save its claims against Mr. Merrill. To begin with, Mr. Merrill could not possibly have been involved in the day-to-day affairs of the company for the vast majority of the class period, as he was not even an officer of the company. Further, plaintiff has not shown what statements or acts it asserts fall under the doctrine.

Taken as a whole and in the context of the entire complaint, the allegations stated in the FACC are not sufficient as to defendant Merrill. Likewise, because plaintiff has not succeeded in pleading a claim against Mr. Merrill as a primary violator, and because plaintiff has made no showing that Merrill had "control" over any primary violator, plaintiff's

claim under § 20(a) must also fail. However, the Court finds that the most prudent course of action is to allow leave to amend, as the general allegations against defendant Merrill, if supported by sufficient facts in corroboration, may be sufficient to state a claim upon which relief can be granted. *Eminence Capital*, 316 F.3d at 1052. Therefore, the Court hereby DISMISSES WITHOUT PREJUDICE the Complaint as to defendant Merrill.

5. *Catherine Kwong Giffen*

The Court finds no substantiated claim against defendant Catherine Kwong Giffen. The allegations against her are extraordinarily weak. The only allegation even worth mentioning is that Ms. Giffen sold stock while in possession of adverse non-public information, and that these sales constituted insider trading. As the Court has already found plaintiff's pleading insufficient as to stock sales in general, no further comment is necessary. Ms. Giffen's stock transactions were not "unusual or suspicious." There is therefore no allegation supporting scienter on her part. Neither her position within the company, Vice President of Human Resources, nor her personal relationship with Mr. Giescke can lead to any inference of deliberate recklessness.

Although the Court finds it doubtful that plaintiff will plead facts in sufficient detail as to Ms. Giffen, the most prudent action at this stage of the litigation is to allow leave to amend, as the general allegations against defendant Giffen, if supported by sufficient facts in corroboration, may be sufficient to state a claim upon which relief can be granted. The FACC is hereby DISMISSED WITHOUT PREJUDICE as to Ms. Giffen.

Appendix B

6. *Sophia Losh*

Sophia Losh was the Senior Vice President of the Strategic Alliances Group ("SAG") at Homestore. For whatever reason, Ms. Losh filed a joinder to the brief of non-analogous party, Cendant Corporation. The Court construes her joinder as a joinder to the general argument of insuffiency of the Complaint. The allegations against Ms. Losh are included in five brief paragraphs, FACC ¶¶ 480-484, and do not include sufficient factual detail to support a strong inference of scienter. However, with additional factual allegations concerning the alleged actions and role of Ms. Losh in the statements or material omissions of Homestore and the general scheme to defraud, the Court finds that plaintiff may be able to state a claim against Ms. Losh. Therefore, Ms. Losh's motion to dismiss is hereby GRANTED with leave to amend, and the Complaint is DISMISSED WITHOUT PREJUDICE as to her.

B. *Outsider Defendants—The "Business Partners" and "Third Party Vendors"*

Seventeen of the defendants presently before the Court are either business partners or third party vendors of Homestore, or employees and/or officers thereof. Those defendants vociferously deny liability for any wrongs in Homestore's transactions, accounting and disclosure procedures, claiming that *Central Bank* and its progeny bar actions against simple "business partners" as a matter of law. In support of this assertion, these defendants point out that most attempts to date to assert liability under the "scheme" prong of Rule 10b-5 have been rejected as equivalent to the

"aider and abettor" liability disallowed by *Central Bank*. They further argue that significant participation in the creation or dissemination of "false or misleading *statements* " is required for liability under § 10(b) and Rule 10b-5. Plaintiff counters that the language of *Central Bank* itself allows for liability to run to secondary *actors*, so long as they have committed independent acts that constitute primary *violations* of Section 10(b) and Rule 10b-5. Plaintiff points to cases within this circuit that have allowed for liability under the "scheme" prong of Rule 10b-5, even after *Central Bank*.

Plaintiff's theory of liability as to the outside defendants is creative and plausible, yet it must fail for three reasons. First, the parties have not cited, and the Court is unaware of, any post-*Central Bank* case that has ever held that a simple business partner to a corporation is liable to the shareholders of that corporation for securities fraud. The Court declines the invitation to be the first. Second, no matter how a "scheme" is defined, *Central Bank* dictates that only those participants who commit "primary violations" of the securities laws may be held liable; those who merely facilitate or participate cannot. Third, in this case, the shareholders of Homestore were damaged by their reliance on statements and material omissions made by Homestore, not the "scheme" itself. Plaintiff's "scheme to make an omission" theory is simply too attenuated to hold outside business partners liable under Section 10(b). Because the Court holds that *Central Bank* precludes liability for ordinary business partners and third party corporations doing business with the primary violator as a matter of law, the FACC is dismissed with prejudice as to those defendants.

Appendix B

1. *The Scope of Securities Fraud Liability*

Prior to *Central Bank*, the lower federal courts had nearly uniformly recognized an implied right of action for aiding and abetting liability under Section 10(b) and Rule 10b-5. The elements of the cause of action were as follows: 1) a primary violation by another person, 2) actual knowledge or reckless disregard by the aider and abettor of the wrong and his role in furthering it, and 3) substantial assistance by the defendant in the achievement of the primary violation. *See e.g. Levine v. Diamanthuset, Inc.*, 950 F.2d 1478, 1483 (9th Cir.1991). Under this cause of action, outside business entities that substantially participated in or assisted with the primary violation were routinely held liable for their aiding and abetting. *See e.g. id. Central Bank* eliminated this implied right of action. That decision also called into question the SEC's authority to bring civil enforcement actions against aiders and abettors. 3 A. Bromberg & L. Lowenfels, *Bromberg and Lowenfels on Securities Fraud and Commodities Fraud* 2ed, Sec. 8.5(610), p. 516.

When Congress was drafting the PSLRA the following year, the Supreme Court's holding and its effect on both private and SEC enforcement actions was a heavily discussed and debated topic. *Id.* In the end, Congress declined to create an express private right of action for aiding and abetting securities fraud, but expressly granted authority to the SEC to bring civil enforcement actions seeking damages and injunctive relief for aiders and abettors in enacting what is now Section 20(f) of the Securities Exchange Act. *Id.*, 15 U.S.C. § 78t(f).

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Private litigants have since turned to the "scheme" prong of Rule 10b-5 in an attempt to reach outside defendants. *See e.g. Stack v. Lobo*, 903 F.Supp. 1361, 1374 (N.D.Cal.1995). While it is clear in some sense that one may be held liable for securities fraud for participation in a "scheme to defraud" even after *Central Bank*, *see Cooper v. Pickett*, 137 F.3d 616 (9th Cir.1998), the Court is unaware of any case since *Central Bank* that has ever held that outside business partners, no matter how involved they were in fraudulent transactions with a corporation, can be held liable in a private action brought by the shareholders of that company. A brief survey of the case law in this circuit demonstrates this point.

First, courts have no trouble finding liability where the actor is a corporate insider, even when that actor claims not to have committed the actual fraudulent statement or act. *Cooper*, 137 F.3d at 624-25 (holding that a corporation that released a misleading report to an analyst who subsequently passed those statements on to the investing public can be held liable for specific acts in furtherance of a scheme to defraud); *Howard v. Everex Systems, Inc.*, 228 F.3d 1057 (9th Cir.2000) (CEO who acted with requisite scienter in signing SEC filings could not escape liability simply because he did not participate in the drafting or editing of the statements). Second, persons "outside" a corporation have been held liable as primary violators in private actions brought by shareholders of that corporation if those persons substantially and directly participated in the creation of false or misleading statements to the investing public. *DSAM Global Value Fund v. Altris Software, Inc.*, 288 F.3d 385, 390 (9th Cir.2002) (auditor may be considered primary violator if sufficient facts

pled); *McGann v. Ernst & Young*, 102 F.3d 390 (9th Cir.1996) (holding that *Central Bank* did not preclude finding of direct liability of accountant based on false information provided in audit); *In re Software Toolworks*, 50 F.3d 615, 628-29 (9th Cir.1994) (underwriter who played a significant role in the review, drafting and editing of letters sent to the SEC liable under Rule 10b-5); *In re ZZZZ Best Secs. Litig.*, 864 F.Supp. 960, 971 (C.D.Cal.1994) (outside accounting firm can be a primary violator for participation in reviewing statements publically released by the company). Thus in every post-*Central Bank* case cited to the Court where an "outsider" has been held liable as a primary violator, that outsider had some type of special relationship with the corporation, i.e. accountant, auditor, etc.

Significantly, these are exactly the types of "secondary actors" the Supreme Court envisioned as potential "primary violators" in *Central Bank*. In holding that there is no "aider and abettor" liability under Section 10(b) of the Securities Exchange Act, the Court noted that:

> The absence of § 10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability under the securities Acts. Any person or entity, *including a lawyer, accountant, or bank*, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming all of the requirements for primary liability under Rule 10b-5 are met. In any complex securities

> fraud, moreover, there are likely to be multiple violators . . .

Central Bank, 511 U.S. at 191, 114 S.Ct. 1439 (emphasis added). Yet the language of the Supreme Court does not suggest, and the subsequent case law does not support, the notion that a business partner with no special relationship with a corporation, let alone its shareholders, can be held liable for the material misstatements or omissions of that corporation or its officers, no matter how much it assisted or participated in transactions that led to that statement or omission. Such a holding would broaden the scope of the securities acts so as to haul into court anyone doing business with a publically traded company. The same policies behind the *Central Bank* decision apply equally here. This Court declines to broaden the scope of the securities acts any further, absent direction from Congress.

2. *The "Scheme" and the "Primary Violator" Requirement*

What defines a "scheme to defraud" is elusive and not well-examined in the case law. However, no matter what the definition of a "scheme" turns out to be, *Central Bank* requires that a plaintiff allege facts that show a primary violation of securities laws by each and every defendant.

Some of the defendants in the present case argue that the "scheme" prong of Rule 10b-5 is simply another name for "aiding and abetting," and is therefore no longer viable after *Central Bank*. See AOL Mot. at 7, *citing Stack v. Lobo*, 903 F.Supp. 1361, 1374 (N.D.Cal.1995). Yet the Ninth

Circuit appears to have held that a person may be liable for participation in a "scheme" even after *Central Bank*. In *Cooper v. Pickett*, 137 F.3d 616 (9th Cir.1998), a corporation made misleading statements to an analyst, who then made statements to the investing public based on those statements. *Id.* at 619. The corporation argued that it could not be held liable because it merely aided the fraudulent act. *Id.* at 624. The court rejected that argument because the corporation had committed its own independent fraudulent act. *Id.* The court specifically held that plaintiff's claim was not a "conspiracy" as a separate right of action, but rather was a claim of an independent act as part of a scheme to defraud. *Id.* "*Central Bank* does not preclude liability based on allegations that a group of defendants acted together to violate the securities laws, *as long as each defendant committed a manipulative or deceptive act* in furtherance of the scheme." *Id.* (emphasis added). *Cooper* establishes that "scheme" and "aiding and abetting" are *not* equivalent. Unfortunately, the term "scheme" was not defined in any meaningful way. In addition, there is no indication that liability for participation in a scheme can extend beyond the corporate officers and those with a special relationship with the corporation.

What is clear, however, is that *Central Bank* requires a plaintiff to allege that each and every defendant committed its own independent primary violation of securities laws in order to state a claim. *Central Bank*, 511 U.S. at 191, 114 S.Ct. 1439. Rule 10b-5 makes it unlawful for any person "to employ any . . . scheme . . . to defraud . . . in connection with any security." The Court resolves this apparent conflict by finding that of the many participants in a "scheme," there may be primary violators and secondary violators. Those who

actually "employ" the scheme to defraud investors are primary violators, while those who merely participate in or facilitate the scheme are secondary violators. In the present case, the primary architects of the scheme are the officers of Homestore who designed and carried out the schemes to defraud. The Court holds that other actors, such as AOL and its employees who actively participated in the triangular transaction scheme, did not "employ" the scheme to defraud investors, and are therefore secondary violators. Therefore, they are "aiders and abettors" within the meaning of *Central Bank*.

Based on the foregoing analysis, the Court holds that a "scheme" within the meaning of the Securities Exchange Act and the PSLRA involves one or more participants acting together to violate securities laws. Those participants may have differing degrees of culpability depending on their role in the scheme. In light of *Central Bank*, only those participants who are "primary violators" of Section 10(b) may be held liable in a private action for securities fraud.

3. *The Requirement of a "Statement" or "Omission"*

Somewhat independent of the *Central Bank* analysis, each of the outside business partners and third party vendors attacks the FACC for failing to identify any false or misleading statements or material omissions attributed to them as opposed to Homestore insiders or its auditor. Nor does the FACC allege in any detail that these defendants played any "significant role" in the drafting or editing of such statements. *In re Software Toolworks*, 50 F.3d 615, 628-29 (9th Cir.1994). So the question arises as to whether a

statement or material omission is required on the part of the defendants in order for the plaintiffs to state a claim.

It is true that no "statement" is required to state a claim under Rule 10b-5, *in general.* For example, a person may be liable for a manipulative "act" or deceptive scheme that operates a fraud on another with respect to the purchase or sale of a security. *SEC v. Zandford*, 535 U.S. 813, 122 S.Ct. 1899, 1903, 153 L.Ed.2d 1 (2002) (broker held liable for conversion of securities from elderly person). In addition, a person may be held liable under Rule 10b-5 for insider trading, which has been considered a deceptive "device." *No. 84 Employer-Teamster v. America West*, 320 F.3d at 937. However, in each of these examples, it was the act or device that actually causes the damage to the injured party.

In the present case, plaintiff suffered damage through its reliance on false or misleading statements, not from the "scheme" itself. Thus, the scheme is one step removed from the injured party. The scheme was not complete until the statement was made. Essentially what plaintiff alleges is a scheme to make a deceptive statement or material omission. Yet the principal "wrong" alleged under the rule is the statement, not the scheme. Therefore, it is appropriate to require defendants in this case to be connected in some material way to the drafting of the statements made to the investing public. Here, this means the SEC filings, the press releases, the oral statements of Homestore, and the supporting statements of its auditor, Pricewaterhouse Coopers. Because plaintiff did not (and cannot) sufficiently allege that any of the business partner or third party vendor defendants substantially contributed to those statements, it cannot state

a claim against those defendants for damages resulting from reliance on statements or material omissions.

While this Court feels compelled to arrive at this result, it does so with reservation. The acts alleged in the FACC, which this Court must accept as true for purposes of this motion, describe a massive conspiracy driven by pure avarice. In particular, the detailed factual allegations describing the role of AOL and its agents in helping Homestore please Wall Street and in boosting its own revenues through bogus commissions give this Court great pause. Nevertheless, the role of AOL and the other business partner and third party vendor defendants appears to be exactly the role of aiders and abettors prior to *Central Bank*, and is exactly the role that *Central Bank* exempted from liability. This decision does not mean that the wrongs of these aiders and abettors will necessarily go unchecked; the PSLRA expressly granted the SEC the authority to bring civil actions against aiders and abettors of securities fraud, and it is this Court's understanding that some investigation is ongoing.

In sum, this Court declines to expand the scope of liability under Section 10(b) and Rule 10b-5 to include business partners of Homestore. No post-*Central Bank* case has ever held that such defendants are liable to the shareholders of a publicly-traded company. Their role in the alleged scheme to defraud investors by artificially inflating the price of Homestore's stock is one of an assistant, an aider or abettor, rather than a primary violator. In addition, plaintiff can point to no independent statements or material omissions of these defendants, nor has it alleged that they substantially contributed to the drafting of any of Homestore's misleading

statements. For all of these reasons, the motions of the business partner and third party vendor defendants are GRANTED. The FACC is DISMISSED WITH PREJUDICE as to the following parties: AOL Time Warner, Eric Keller, David Colburn, Cendant Corporation, Richard Smith, L90, Akonix, CityRealty, Classmates Online, CornerHardware, Dorado Corporation, GlobeExplorer, Internet Pictures, PromiseMark, RevBox, SmartHome, and WizShop.

Because the Court finds that plaintiff's action under Section 10(b) (and therefore under Section 20(a)) is precluded as to these defendants as a matter of law, the Court does not address the sufficiency of the Complaint as to those parties.

C. *Auditor Defendant—Pricewaterhouse Coopers*

It is well-established in the Ninth Circuit that an outside auditor of a publicly-held company can be held liable as a primary violator under Central Bank. *DSAM Global Value Fund v. Altris Software, Inc.*, 288 F.3d 385 (9th Cir.2002); *In re Software Toolworks, Inc.*, 50 F.3d 615 (9th Cir.1994). Therefore, Pricewaterhouse Coopers brings this motion to dismiss by challenging the sufficiency of the allegations in the complaint. The Court finds that plaintiff has pled facts sufficient to give rise to the requisite "strong inference" that PWC acted with "intent to defraud, conscious misconduct, or deliberate recklessness," as required by the PSLRA. *DSAM Global*, 288 F.3d at 390.

A plaintiff alleging a violation of Section 10(b) and Rule 10b-5 against an independent auditor such as PWC must satisfy the requirements of the PSLRA by alleging with

specificity that "the accounting practices were so deficient that the audit amounted to no audit at all, or an egregious refusal to see the obvious, or to investigate the doubtful, or that the accounting judgments which were made were such that no reasonable accountant would have made the same decisions if confronted with the same facts." *DSAM Global*, 288 F.3d at 390; *citing In re Worlds of Wonder Secs. Litig.*, 35 F.3d 1407, 1426-27 (9th Cir.1994).

From the outset, the Court notes that many of the same factual allegations that PWC touts as evidence of an auditor "doing its job" ironically also show scienter in the securities fraud context. The fact that PWC on many occasions "questioned" certain transactions and "objected" to others shows that the PWC's auditors knew of the questionable nature of Homestore's accounting. The fact that they let many of these transactions proceed demonstrates "an egregious refusal to see the obvious."

PWC relies heavily on two post-*Central Bank* auditor liability cases, *DSAM Global Value Fund v. Altris Software, Inc.*, 288 F.3d 385 (9th Cir.2002) and *In re Software Toolworks, Inc.*, 50 F.3d 615 (9th Cir.1994). The Court first examines this authority, then demonstrates how the plaintiff in the present case has pled substantially more than was pled against the auditor defendants in those two cases.

In *DSAM Global*, Pricewaterhouse Coopers certified that Altris Software, Inc.'s ("Altris") 1996 Form 10-K financial statement complied with Generally Accepted Accounting Principles ("GAAP") and that Pricewaterhouse Coopers had complied with Generally Accepted Auditing Standards

("GAAS"). 288 F.3d at 388. Altris then filed its financial statement with the SEC and included the audit certification, both affirming that the company had posted net income of $2.4 million for the year. *Id.* One year later, in preparing the 1997 audit, PWC discovered that the 1996 statement reflected revenue that should not have been recognized, and withdrew its audit opinion. *Id.* Altris then restated its revenues for 1996, reversing $4.9 million in previously recognized revenue, causing the company to post a net loss rather than a net profit for that year. *Id.*

Investors filed suit, in essence alleging that "Altris recognized revenue on software sales before critical requirements had been met, making its 1996 sales and earnings appear larger than they really were," and that PWC had "failed to take the necessary steps to test those sales to provide a reasonable basis for the audit opinion it issued." *Id.* at 389. Specifically, plaintiffs asserted: 1) that PWC failed to recognize three accounting "red flags" regarding start up fees for software sales, and 2) that PWC had not followed the GAAS in auditing the recognition of revenue for software sales. *Id.* The alleged red flags were: "grossly exorbitant" fees charged by Altris, the timing of the recognition of the fees at the end of the year, and the fact that the contract documents described the transactions as special. *Id.* As to revenue recognition, plaintiffs alleges that PWC had failed to catch Altris' repeated violations of a GAAP, specifically the Software Revenue Recognition Statement of Position 91-1 ("SOP 91-1"), which only allows for software revenue recognition when seven specific conditions have been met. *Id.* Yet plaintiffs' primary allegation was that PWC must have been aware of improper revenue recognition simply because

they were in possession of documents that clearly showed the violation. *Id.*

The court in *DSAM* rejected the plaintiffs' allegations as insufficient to state a claim under Section 10(b) and Rule 10b-5. The Court did not examine the relevance of the "red flags," but did state that mere possession of documents depicting improper revenue recognition was not enough to show scienter. *Id.* at 390. The court specifically found that the plaintiffs had "failed to allege any facts to establish that [PWC] knew or must have been aware of the improper revenue recognition, intentionally or knowingly falsified the financial statements, or that the audit was such an extreme departure from reasonable accounting practice that [PWC] knew or had to have known that its conclusions would mislead investors." *Id.* at 390-91.

Similarly in *Software Toolworks*, plaintiffs provided circumstantial evidence that the accountant in the case knew about or recklessly disregarded errors in the financial statements. 50 F.3d at 627. Specifically, plaintiffs alleged that sales agreements were "poorly documented, informal and conditional," that certain "licensing transactions were risky," that management was "under extraordinary pressure for favorable earnings," and that the accountant obtained only oral confirmations of some agreements. *Id.* However, the court detailed the steps that the accountant took in preparing its audit, and found that the allegations did not establish that the audit was reckless. *Id.* The court stated, "At most, the evidence establishes that [the accountant] was negligent in auditing [the company], not that [the accountant] recklessly or knowingly falsified the financial statements". *Id.* The

plaintiffs had failed to show specific facts demonstrating the accountant's knowledge or state of mind when issuing its audit.

The case before the Court is factually distinguishable. The Complaint filed by the plaintiff describes an auditor that 1) was heavily involved in the day-to-day accounting practices of the company, 2) had actual knowledge of specific improper transactions and the accounting thereof, 3) even objected to some of these transactions but not to identical transactions, and 4) nonetheless issued an unqualified audit opinion certifying that Homestore's publicly filed financial statements complied with the GAAP and that its auditing complied with the GAAS. More than with any other defendant in this action, plaintiff establishes a strong inference that PWC acted with deliberate indifference, if not conscious misconduct, when it refused to see the obvious, or to investigate the doubtful, improper transactions and revenue recognition carried out by Homestore and its officers. The FACC alleges scienter through so many examples that the Court will not detail each and every one here. The following are a few of the more significant allegations giving rise to the inference of scienter.

First, the Court begins with the fact that this is a restatement case. Under GAAP, the restatement of previously issued financial statements is reserved for circumstances where no lesser remedy is available. In conjunction with Homestore's FYE 2000 SEC filing and annual report to its shareholders, PWC issued an unqualified audit report that stated: "In our opinion, this financial statement presents fairly, in all material respects, the information set forth therein

when read in conjunction with the related consolidated financial statements." FACC ¶ 649. In March of 2002, however, Homestore restated *seven quarters* of revenue. FACC ¶ ¶ 655, 657. Unlike the defendant in *DSAM* where the restatement involved a total of $4.9 million, Homestore restated a total of $193 million in revenue, constituting 52.8% of all advertising revenue and 22.8% of total revenue for that time period. FACC ¶ ¶ 654-57. This evidences an accounting and auditing debacle amounting to more than gross negligence.

Next, plaintiff details several accounting "red flags" (known as "risk factors" in the GAAS, AU §§ 316.16-316.17) that PWC was confronted with and to which it did not react or respond. The most significant of these red flags was the fact that on numerous occasions, major transactions took place within the last few days of the quarter. *See generally* FACC ¶ 578; *see also, e.g.* FACC ¶ ¶ 331-339, 359-360, 618. Unlike the transactions that are described in *DSAM* that occurred once at the end of the year, the transactions detailed in the FACC repeatedly occurred at the end of the quarter. Another red flag occurs when management sets unduly aggressive financial targets and expectations for operating personnel. Plaintiff has alleged this in detail, and the Court must accept its allegations as true for purposes of this motion. FACC ¶ ¶ 578, 328, 347, 439, 585. The FACC details several other risk factors not discussed here that were ignored by PWC. FACC ¶ ¶ 537-34.

Plaintiff also details various GAAP provisions that Homestore violated that were not recognized in PWC's audit, as well as the GAAS provisions PWC violated in performing

this defective audit. First and foremost, one of the principal issues in the late 1990s was how to properly account for "barter-type" transactions. In January 2000, at the beginning of the class period, the Financial Accounting Standards Board made effective "Emerging Issues Task Force ("EITF") Issue No. 99-17," entitled "Accounting for Advertising Barter Transactions." FACC ¶ 545. Such transactions could only be recorded if the fair value of the advertising surrendered in the transaction could be determined based on the company's own historical practices of receiving cash or cash equivalents for similar advertising sold to unrelated entities. FACC ¶ 546. Similarly, EITF 99-19, also effective prior to the class period, dealt with recognition of gross revenues versus net. FACC ¶ 550-551. Many of Homestore's reciprocal "barter-type" transactions were alleged to have violated both of these rules. FACC ¶ 148-152, 607-611. Interestingly, PWC required some of these transactions to be netted, while it allowed others to be reported as gross. *Id.* and 612-623. PWC also did not always require the proper valuation for advertising. *Id.* The Court draws the logical inference that because PWC objected to some transactions, it knew that the transactions and the accounting of them were improper. The fact that it also allowed some of them to be reported as gross without proper valuation shows that PWC acted with deliberate recklessness in failing to properly audit Homestore's transactions and accounting practices.

The Court also notes that such allegations are explained in sufficient detail. For example, paragraph 628 explains that the issue of gross versus net accounting under EITF 99-19 was discussed in detail at a Homestore Audit Committee meeting at which PWC's Withey was present. "Whithey did

not object to [past] booking on a gross basis, but . . . in light of the concerns expressed, the use of the gross proceeds would not be allowed again . . . [this decision] allowed the gross revenues of a fraudulent transaction to be booked in the first quarter of 2001." FACC ¶ 628. Thus this is not a case like *DSAM*, where the Court found absolutely no factual allegations showing that the auditor in that case knew anything or acted with reckless disregard.

The Court hereby finds that the FACC sufficiently alleges facts that give rise to the requisite "strong inference" that PWC acted with deliberate recklessness when it issued its audit opinion for Homestore's FYE 2000 statements to the SEC and the shareholders, and for its substantial participation in the preparation of various quarterly reports. Pricewaterhouse Coopers' motion to dismiss is hereby DENIED.

CONCLUSION

Having considered the pleadings and papers filed by the parties, and having heard oral argument on the issues, the Court rules as follows based on the foregoing analysis:

1) The motions of the following defendants are hereby DENIED: Stuart H. Wolff (Dkt. No. 126), Pricewaterhouse Coopers, (Dkt. No. 185);

2) The motions of the following defendants are GRANTED, and the complaint as to such defendants is DISMISSED WITHOUT PREJUDICE: David Rosenblatt (Dkt. No. 116), Allan Merrill (Dkt. No. 104), Catherine Kwong Giffen (Dkt. No. 204), Sophia Losh (Dkt. No. 117);

3) The motions of the following defendants are GRANTED, and the complaint as to such defendants is DISMISSED WITH PREJUDICE: AOL Time Warner (Dkt. No. 122), Eric Keller (Dkt. No. 203), David Colburn (Dkt. No. 111), Cendant Corporation (Dkt. No. 202), Richard Smith (Dkt. No. 202), L90 (Dkt. No. 205), Akonix (Dkt.Nos.108-109), CityRealty (Dkt. Nos. 108, 113), Classmates Online (Dkt. No. 110), CornerHardware (Dkt. No. 108), Dorado Corporation (Dkt. No. 108), GlobeExplorer (Dkt. No. 100), Internet Pictures (Dkt. No. 108), PromiseMark (Dkt. No. 108), RevBox (Dkt. No. 108), SmartHome (Dkt. No. 108), and WizShop (Dkt. No. 153).

This order does not include or cover named defendants Privista, Inc, Top Producer Systems, Inc., or Jeff Kalina. Privista's Motion to Dismiss (Dkt. No. 209) was filed on February 24, 2003, and therefore will be noted for consideration on March 21, 2003, unless agreed otherwise by the parties.

The Clerk is directed to send a copy of this order to all counsel of record.

(2)

FILED
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SUPREME COURT, U.S.

No. 06-560

IN THE

Supreme Court of the United States

AVIS BUDGET GROUP, INC. a/k/a CENDANT CORPORATION, TIME WARNER INC., RICHARD A. SMITH, DAVID COLBURN and ERIC KELLER,

Petitioners,

v.

CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether *certiorari* should be denied in this case due to mootness and lack of standing because there is no current case pending against Petitioners since Respondent's motion for leave to amend to file an amended complaint was denied as to Petitioners, and that ruling is currently on appeal.

2. Whether a person may be primarily liable under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), for engaging in a "scheme to defraud," where that person engaged in conduct that had the principal purpose and effect of creating a false appearance of fact in the furtherance of a scheme to defraud, and where the misconduct of the person satisfied all elements required for primary liability under Section 10(b). *Simpson v. AOL Time Warner, Inc.*, 452 F.3d 1040 (9th Cir. 2006) ("*Homestore*").

LIST OF PARTIES

As noted in the Petition, Defendant-Respondent MaxWorldwide, Inc., fka L90, Inc. did not join in the original Petition and is not a Petitioner.

Pursuant to Supreme Court Rule 29.6, California State Teachers' Retirement System states that it is a governmental agency pursuant to California Education Code Section 22000 *et seq.*; hence no corporate disclosure is required.

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STATEMENT OF JURISDICTION

On June 30, 2006, the Ninth Circuit Court of Appeals entered its judgment. On September 21, 2006, this Court extended the time to file this Petition to November 13, 2006. This Petition was then filed on October 21, 2006. On December 26, 2006, this Court extended the time within which to file a response to the Petition to February 7, 2007. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTORY AND REGULATORY PROVISIONS INVOLVED

Section 10(b) of the Securities and Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5(a), (b) and (c), promulgated thereunder, 17 C.F.R. § 240.10b-5.

§ 78j Manipulative and deceptive devices

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any national securities exchange –
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange, or any security not so registered, or any securities-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act), any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission

may prescribe as necessary or appropriate in the public interest for the protection of investors.

15 U.S.C. § 78j(b).

§ 2401.10b-5 Employment of Manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility or any national securities exchange,

(a) To employ any device, scheme or artifice to defraud,

(b) To make any untrue statement of material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5.

STATEMENT OF THE CASE

I. Factual Background And Allegations

Beginning in December 2001, class action complaints were filed against Homestore.com, Inc. ("Homestore"),[1] an internet company that provides real estate and home ownership services, and other individuals and entities on behalf of persons who purchased shares of Homestore common stock. The United States Court for the Central District of California consolidated these actions in a proceeding entitled *In re Homestore.com, Inc. Sec. Litig.*, Case No. CV 01-11115 MJP (the "Action") and approved the appointment of Respondent California State Teachers' Retirement System ("CalSTRS"), a pension fund for California's public school teachers, as Lead Plaintiff for the putative Class.

On November 15, 2002, Lead Plaintiff filed the operative First Amended Consolidated Complaint in the Action (the "Complaint") that alleges, among other things, that in an unlawful scheme to artificially inflate the value of Homestore common stock, Homestore's financial statements were materially misstated.

> Plaintiff alleges in its complaint that several Homestore insiders, with the knowledge of Homestore's auditor and the active participation of various outside business entities, unlawfully created revenue through various types of dubious transactions in order to prop up Homestore's stock price. Plaintiff claims that these transactions, combined with improper accounting and the release of written and oral public statements made to the SEC, analysts, and the general public, perpetrated a fraud on Homestore's shareholders and the investing

1. In 2006, Homestore.com, Inc. changed its name to Move, Inc., which can be found on the internet at *http://www.move.com.*

> public in violation of Federal securities statutes and regulations promulgated thereunder. Eventually, Homestore was forced to restate seven quarters of revenue because of the improper transactions and accounting. By this action, plaintiff seeks to recover damages incurred when the market price of Homestore common stock fell dramatically once the need for restatement became public.

Pet. App. 32a-33a.

The Complaint alleges that Homestore and Petitioners Cendant Corporation, Time Warner, Inc., Richard A. Smith, David Colburn, and Eric Keller, and Defendant L90, Inc. ("L90"), among other wrongful acts, engaged in improper transactions, including round-trip transactions. Pet. App. 41a-47a. The District Court summarized the allegations in the Complaint:

> Plaintiff alleges that America Online Time Warner ("AOL") was a major player in arranging many of the illicit revenue boosting transactions. AOL employees David Colburn and Eric Keller are also named as defendants for their roles as the primary Homestore contacts within AOL and the architects of many of the improper "round trip" transactions. Both were released by AOL under suspicion of certain illegal transactions with Homestore and other companies. Plaintiff does allege, however, that the transactions continued after the two individuals left, further implicating AOL in the scheme to defraud.
>
> Cendant Corporation ("Cendant") is a major player in the on-line real estate business, and has substantial activities in the car rental and travel industries as well. Plaintiff alleges that Cendant and its CEO Richard Smith engaged in "triangular" transactions

> between Homestore, Cendant and one of Cendant's subsidiaries. This transaction also represents a "related party" transaction that was not appropriately accounted for as such.
>
> L90 is a media company. Plaintiff alleges that L90 engaged in illegal "triangular" transactions and "barter" transactions with Homestore and third parties.

Pet. App. 37a.

The Complaint further alleges that Lead Plaintiff and the other members of the Class purchased or acquired Homestore common stock at prices that were artificially inflated as a result of the dissemination of Homestore's materially false and misleading financial statements in violation of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78j(b) and 78t, and Rule 10b-5, 17 C.F.R. 240.10b-5, promulgated thereunder. Pet. App. 33a; 82a.

II. District Court Proceedings

In January 2003, Petitioners and other defendants moved to dismiss the Complaint on the grounds that the Complaint did not state a claim under Section 10(b). In an opinion and order dated March 7, 2003, the District Court dismissed with prejudice the claims against Petitioners and other defendants. The District Court concluded that the Complaint alleged aiding and abetting conduct which is insufficient to state a claim under Section 10(b) under this Court's ruling in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994) ("*Central Bank*") because the Petitioners and L90 were alleged to have merely assisted the commission of a deceptive act. Pet. App. 81a. In making this ruling, the District Court stated:

> While this Court feels compelled to arrive at this result, it does so with reservation. The acts alleged

> in the FACC [the Complaint], which this Court must accept as true for purposes of this motion, describe a massive conspiracy driven by pure avarice. In particular, the detailed factual allegations describing the role of AOL and its agents in helping Homestore please Wall Street and in boosting its own revenues through bogus commissions give this Court great pause. Nevertheless, the role of AOL and the other business partner and third party vendor defendants appears to be exactly the role of aiders and abettors prior to *Central Bank*, and is exactly the role that *Central Bank* exempted from liability.

Pet. App. 81a (bracketed material added).

III. The Decision Below

Respondent CalSTRS appealed to the United States Court of Appeals for the Ninth Circuit. After reviewing the allegations in the Complaint, the Ninth Circuit concluded that: "Plaintiff's complaint insufficiently alleged that Defendants were primary violators of § 10(b) based on their conduct in the furtherance of the scheme." *Homestore*, 452 F.3d at 1043; Pet. App. 3a. Hence, the Ninth Circuit *affirmed* the District Court's dismissal of the Complaint, but r*emanded* to permit CalSTRS to seek leave to amend the complaint "if that can be done consistent with this opinion." *Id.* at 1055; Pet. App. 16a.

In its opinion, the Ninth Circuit followed this Court's holding in *Central Bank* that "§ 10(b) does not allow recovery for aiding and abetting liability" *Id.* at 1042; Pet. App. 3a citing *Central Bank*, 511 U.S. at 177-178. Since this Court in *Central Bank* did not fully define the scope of primary liability, *id.*, the Ninth Circuit relied upon the language of Section 10(b), this Court's precedents, and the Securities and Exchange Commission's ("SEC") test to determine if allegations that Petitioners engaged in a "scheme to defraud" to overstate the

revenues of Homestore stated a claim under Section 10(b). *Id.* at 1043; *see id.* at 1048; Pet. App. 3a; 15a-16a. The Ninth Circuit held that a defendant may be held primarily liable under Section 10(b) for a scheme to defraud if the defendant's *own conduct* had "the principal purpose and effect of creating a false appearance of fact in furtherance of the scheme." *Id.* at 1048 (emphasis added); Pet. App. 16a. Mere participation in a transaction that had a deceptive purpose and effect is insufficient for primary liability. *Id.* This test serves as "an aid to assessing whether the defendant's conduct was sufficiently deceptive for § 10(b) liability." *Id.* at 1048 n.5; Pet. App. 17a.[2]

The Ninth Circuit reasoned that, by itself, the *scienter* requirement cannot distinguish aiding and abetting from primary liability because while a defendant may intend to deceive the public by assisting another's misconduct as part of a scheme to defraud, the defendant may fail to engage in conduct that created a false appearance in furtherance of the fraudulent scheme. *Id.* Unlike the element of *scienter*, the examination of the "principal purpose and effect" of the defendant's conduct allows a court to differentiate aiding and abetting from conduct that constitutes a primary violation under Section 10(b). *Id.* The court clarified that

> [n]or is 'scheme to defraud' liability a substitute for aiding and abetting liability that the Supreme Court

2. In an *amicus curiae* brief in the proceedings below, the SEC proposed the following test for primary liability: "Any person who directly or indirectly engages in a manipulative or deceptive act as a part of a scheme of scheme to defraud can be a primary violator." The Ninth Circuit did not strictly follow the SEC's definition of "deceptive act" as "engaging in a transaction whose principal purpose and effect is to create a false appearance of revenues." The Ninth Circuit concluded that involvement in a transaction that had a deceptive purpose and effect was insufficient, and that the defendant's *own conduct* must have had a deceptive purpose *and* effect. *Homestore*, 452 F.3d at 1048; Pet. App. 15a to 16a.

> precludes in *Central Bank*. The focus of the inquiry on the defendant's own conduct ensures that only primary violators (that is, only defendants who use or employ a manipulative or deceptive device) are held liable under the Act.

Id. at 1049; Pet. App. 18a.

The Ninth Circuit concluded that conduct that meets these requirements may be considered "in connection with" the purchase or sale of securities if it is part of a scheme to misrepresent publicly reported financial information where the scheme will not be complete until the fraudulent information is introduced into the securities market. *Id.* at 1051; Pet. App. 21a. If several defendants used or employed a deceptive device in furtherance of a scheme to misrepresent financial information, then all such defendants may be viewed as having acted in connection with the purchase or sale of securities. *Id.*

Regarding the element of reliance, the Ninth Circuit held that the requirement is met if the introduction of misleading statements was the intended end result of a scheme to misrepresent financial information. *Id.* at 1051-1052; Pet. App. 21a-23a. The Ninth Circuit followed the fraud on the market presumption of reliance that this Court endorsed in *Basic v. Levinson*, 485 U.S. 224, 247 (1988).

In response to the decision below, on September 29, 2006, CalSTRS moved the District Court for leave to file a Second Amended Consolidated Complaint ("Amended Complaint"). The Amended Complaint contained numerous new allegations against each of the Petitioners, and L90, based on facts that became available only after the filing of the Complaint in November 2002. Such newly available facts came from discovery, testimony in the criminal trial of former Homestore

Chief Executive Officer Stuart Wolff,[3] and plea agreements (*e.g*, from Mark Roah and other senior executives of L90). Despite the substantial new allegations in the Amended Complaint, CalSTRS's motion for leave to file the proposed Amended Complaint was *denied* by Judge Ronald S.W. Lew on December 18, 2006 as to all Petitioners on the grounds that amendment would be futile. The motion for leave to amend was granted only as to L90. Respondent has filed an appeal from the ruling denying it leave to amend.

Accordingly, the Petitioners' claim that the Ninth Circuit's opinion "will serve as a portal for plaintiffs to bring a species of 'aiding and abetting' claims against secondary actors," Pet. at 27, is proved incorrect by virtue of the District Court's denial of Respondent's motion to file the Amended Complaint. Even though the Complaint was based on allegations from inside sources "who were most probably former executives at Homestore and therefore provide a unique insight not generally available to most private securities litigants" and "four former Homestore executives have pled guilty to various criminal charges," *Homestore*, 252 F. Supp. 2d at 1020; Pet. App. 33a, both the District Court and the Ninth Circuit found Respondent's allegations in the Complaint insufficient to state a claim. *Id.* at 1045, 452 F.3d at 1055; Pet. App. 90a, 30a to 31a.

SUMMARY OF ARGUMENT

As a threshold matter, the Petition should be denied on the grounds of mootness. On remand after the Ninth Circuit's opinion, the District Court denied Respondents' motion for leave to file an Amended Complaint and dismissed all the Petitioners

3. On June 22, 2006, Mr. Wolff was convicted on eighteen felony counts, including insider trading, filing false reports with the SEC, and conspiracy, for orchestrating a scheme to inflate Homestore's revenues in 2001 through round-trip transactions. C.D. Cal. Case No. CR 05-398 PA.

from the suit. Since Respondent has appealed the District Court's order denying leave to amend and there is no case pending against Petitioners, this Court should not grant the Petition.

The Ninth Circuit followed the language of Section 10(b) and this Court's holding in *Central Bank*, 511 U.S. at 164 that there is no aiding and abetting liability under Section 10(b) when it determined that the allegations in Respondent's Complaint did not meet the requirements for primary liability under subparts (a) and (c) of Rule 10b-5. The decision below is also supported by decisions of this Court, and is consistent with other courts of appeals that have addressed the same issue.

Despite this lack of conflict, Petitioners' Petition rests on three grounds. First, Petitioners claim that the decision below conflicts with four other circuit courts. Second, Petitioners argue that the decision below is in conflict with *Central Bank*. Third, Petitioners claim that certiorari should be granted for policy reasons.

None of the Petitioners' claims has merit. The first claim is based on an incomplete reading of the decision below and this Court's precedents. The second claim does not recognize this Court's decisions regarding the distinction in claims under different subparts of Rule 10b-5. The policy reasons lack merit because the opinion does not provide a "portal for plaintiffs to bring a species of 'aiding and abetting' claims", Pet. at 27. As demonstrated by the lower courts' rulings that Respondent's allegations were insufficient, even though there were detailed facts concerning the fraud, information supplied by insiders of the company and criminal pleas, the Ninth Circuit's standard for pleading a primary liability claim under Section 10(b) is high. Review of the decision below is therefore unwarranted.

REASONS FOR DENYING THE PETITION

I. The Petition Should Be Denied On The Grounds Of Mootness

The Petition should be denied because it is moot. This Court stated in *North Carolina v. Rice*, 404 U.S. 244, 246 (1971) that "it has frequently been repeated that federal courts are without power to decide questions that cannot affect the rights of litigants in the case before them." This Court explained that "a case is moot when the issues presented are no longer 'live' or the parties lack a legally cognizable interest in the outcome." *City of Erie v. Pap's A.M.*, 529 U.S. 277, 287 (2000). The existence of a concrete and definite controversy is a Constitutional requirement for judicial review. *Rice*, 404 U.S. at 246.

Here, the issues raised by the Petition are moot. On December 18, 2006, the District Court denied Plaintiff-Respondent's motion for leave to file an Amended Complaint as against the Petitioners on the grounds that amendment would be futile under the decision below. Respondent is currently appealing that order.[4]

None of the Petitioners has a legal interest in the issue presented by the Petition because they have all been dismissed from the suit. There is no live controversy, and all questions raised by the Petition are moot. Because "moot questions require no answer," *Missouri, Kansas & Texas R. Co v. Ferris*, 179 U.S. 602, 606 (1900), the Petition should be denied.

---

4. The District Court allowed Respondent to file the amended complaint against L90, who is not a Petitioner in this Petition.

II. The Decision Below Comports With This Court's Precedents Regarding Liability Under Section 10(b)

A. This Court in *Central Bank* Did Not Address the Issue of Primary Liability under Section 10(b) for a Scheme to Defraud

This Court in *Central Bank* granted *certiorari* "to resolve the continuing confusion over the existence and scope of the § 10(b) aiding and abetting action." *Id.* at 170. As stated by the Ninth Circuit in this case: "The Supreme Court held in *Central Bank* that § 10(b) does not allow recovery for aiding and abetting liability, . . ." *Homestore*, 452 F.3d at 1042; Pet. App. 3a citing *Central Bank*, 511 U.S. at 191.

While *Central Bank* addressed the viability of the aiding and abetting action, it did not fully define the scope of primary liability under Section 10(b), *Homestore*, 452 F.3d at 1043; Pet.App. 3a, or address whether a scheme to defraud could satisfy the requirements of primary liability, the issue before the Ninth Circuit. *Id.* at 1048; Pet. App. 15a. To the extent that the decision below involved a different issue from *Central Bank*, it does not conflict with *Central Bank.*

Petitioners attempt to create a conflict by asserting that the only conduct which violates Section 10(b) is "the making of a material misstatement (or omission) or the commission of a manipulative act." Pet. at 15. In support of their argument, Petitioners rely upon the following statement from *Central Bank:* "As in earlier cases considering conduct prohibited by 10(b), we again conclude that the statute prohibits *only* the making of material misstatement (or omission) or the commission of a manipulative act." Pet. at 15 citing 511 U.S. at 177 (emphasis added by Petitioners).

The issue of scheme liability, however, was not before the Court in *Central Bank*. As the SEC pointed out, in the proceedings below, this statement "was not necessary for the

Supreme Court, in deciding that aiding and abetting is not covered by the statutory language, to determine the full extent of deceptive conduct covered by Section 10(b) – an issue not raised by the case or briefed by the parties." SEC *Amicus Curiae* Reply Brief at 2 to 3. Accordingly, there is no conflict between the Ninth Circuit's decision and *Central Bank*.

Nor is there a prohibition under Section 10(b) for liability arising from a scheme to defraud. This Court has emphasized on numerous occasions that Section 10(b) "should be 'construed not technically and restrictively, but flexibly to effectuate its remedial purposes.'" *See e.g. SEC v. Zandford*, 535 U.S. 813, 819 (2002) quoting *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. at 128, 151 (1972). This Court has also recognized that Section 10(b) prohibits all fraudulent schemes:

> [We do not] think it sound to dismiss a complaint merely because the alleged scheme does not involve the type of fraud that is 'usually associated with the sale or purchase of securities.' We believe that § 10(b) and Rule 10b-5 prohibit *all fraudulent schemes* in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception. Novel or atypical methods should not provide immunity from the securities laws.

Superintendent of Ins. of New York v. Bankers Life, 404 U.S. 6, 11 n.7 (1971) quoting *A. T. Brod & Co. v. Perlow*, 375 F.2d 393, 397 (2nd 1967) (emphasis in original and added; internal citation omitted). The proscriptions in Section 10(b) and Rule 10b-5 "are broad and, by repeated use of the word 'any,' are *obviously meant to be inclusive*." *Affiliated Ute*, 406 U.S. at 151 (emphasis added).

B. The Ninth Circuit Decision Follows the Language of Section 10(b) and this Court's Precedents

Section 10(b) of the Securities Exchange Act of 1934 prohibits (1) the "use or employ[ment] . . . of any . . . deceptive device or contrivance"; (2) by "any person"; (3) "in connection with the purchase or sale of any security"; and (4) "in contravention of" Securities and Exchange Commission "rules and regulations." 15 U.S.C. § 78j(b) (bracketed material added).

This Court has defined "device" to include a "scheme" and a "scheme to deceive." Regarding the scope of Section 10(b), this Court addressed the meaning of "device" and "contrivance" in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), which Petitioners cite for the proposition that Section 10(b) prohibits only conduct that is "manipulative or deceptive" within the meaning of the statute. Pet. at 14 citing *Hochfelder*, 425 U.S. at 213-214. In reference to the term "device," this Court in *Hochfelder* refers to the Webster's International Dictionary (2d ed. 1934) for the definition of "device" as "[t]hat which is devised, or formed by design; a contrivance; an invention; project; *scheme; often, a scheme to deceive . . .*" *Id.* at 199 n.20 (emphasis added); *see also Homestore*, 452 F.3d at 1047; Pet.App. at 13a-14a. Since this Court has defined a "device" as a scheme or scheme to deceive, a "scheme to defraud" theory of liability falls within this Court's interpretation of the scope of Section 10(b) liability.[5] This definition of "device" is consistent with the remedial purposes of the statute.

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5. *Chiarella v. United States*, 445 U.S. 222, 236 (1980) does not stand for the broad proposition, as Petitioners claim, Pet. at 14-15, that "deceptive" conduct only includes "the common law categories of a misrepresentation or an omission if there is a duty to disclose." The question before this Court in *Chiarella* was "whether a person who learns from the confidential documents of one corporation that it is planning an attempt to secure control of a second corporation violates

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The language of Rule 10b-5, 17 C.F.R. § 240.10b-5, promulgated by the SEC is also instructive. As this Court has explained, "[t]he scope of Rule 10b-5 is coextensive with the coverage of § 10(b), see *United States v. O'Hagan*, 521 U.S. 642, 651 (1997); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 214 (1976)." *Zandford*, 535 U.S. at 816 n.1.

Rule 10b-5 contains three subparts, (a), (b) and (c) that prohibit certain actions in connection with the purchase or sale of any security. The three subparts of Rule 10b-5 are enumerated in the disjunctive, as the "or" after subpart (b) makes clear. Rule 10b-5(b) makes it unlawful "[t]o make any untrue statement of a material fact necessary in order to make the statements made, in light of the circumstances in which they were made, not misleading." 17 C.F.R. § 240.10b-5 (1976). Subparts (a) and (c) of Rule 10b-5 respectively prohibit the use of "any device, practice, *or* artifice to defraud," or "any act, practice, *or* course of business which operates *or* would operate as a fraud *or* deceit upon any person." *Id.* (Emphasis added).

While subpart (b) prohibits the making of misrepresentations and omissions, the inclusion of the words "any" and "or" in subparts (a) and (c) clearly demonstrates that Section 10(b) and Rule 10b-5 forbid methods other than misrepresentations and omissions that may be used to defraud investors.

Section 17(a) of the Securities Act of 1933, which makes unlawful fraudulent interstate transactions, is analogous to Rule 10b-5 in that the disjunctive language "or" is present in both of

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§ 10 (b) of the Securities Exchange Act of 1934 if he fails to disclose the impending takeover before trading in the target company's securities." *Id.* at 224. This Court held that the conduct did not violate Section 10(b): "When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak. We hold that a duty to disclose under § 10(b) does not arise from the mere possession of nonpublic market information." *Id.* at 235.

them, and an infinitive is used to introduce each of the three subparts. In construing Section 17(a), this Court concluded that "each subsection proscribes a distinct category of misconduct. Each succeeding prohibition is meant to cover additional kinds of illegalities – not to narrow the reach of the prior sections." *United States v. Naftalin*, 441 U.S. 768, 774 (1979) citing *United States v. Birrell*, 266 F. Supp. 539, 542 (S.D.N.Y. 1967). Based upon the same disjunctive language in both Section 17(a) and Rule 10b-5, the analysis of this Court in *Naftalin*, should apply to Rule 10b-5.

While the vast majority of private actions alleging Rule 10b-5 violations concern misrepresentations or omissions, or conduct prohibited by subpart (b) of Rule 10b-5, *see In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472, 497 (S.D.N.Y. 2005), subparts (a) and (c) are also subparts of Rule 10b-5 whose violation gives rise to liability. Failure to give effect to subparts (a) and (c) would render them mere surplusage, in contravention of the canon of statutory interpretation requiring a court to give effect to each word of a statute if possible. *See Alaska Dep't. of Envtl. Conservation v. E.P.A.*, 540 U.S. 461 (2004) (this Court recognized cardinal principle that a statute ought to be construed to prevent any clause, sentence, or word from being rendered superfluous, void, or insignificant); *Duncan v. Walker*, 533 U.S. 167 (2001) (this Court reluctant to treat statutory terms as surplusage in any setting). As a result, subparts (a) and (c) cannot be ignored or written out of the statute, since those subparts were neither inadvertently inserted nor in conflict with the rest of Section 10(b) or Rule 10b-5. The language of subparts (a) and (c) of Rule 10b-5 must be given effect.

Petitioners claim that there is no decision in which this Court has found Section 10(b) liability absent manipulation or deception within the meaning of the statute. Pet. at 14, 15 n.5. However, consistent with this Court's recognition of the distinction in claims under Rule 10b-5(b) versus claims under

Rule 10b-5(a) and (c), this Court has stated that Section 10(b) reaches deceptive "practices," *Santa Fe Ind., Inc. v. Green*, 430 U.S. 462, 475-476 (1977), deceptive "conduct," *id.* at 475 n.15; *O'Hagan*, 521 U.S. at 659, and deceptive "acts," *Central Bank*, 511 U.S. at 173; *see Bankers Life*, 404 U.S. at 9. Reaffirming this interpretation of Section 10(b), this Court recently stated that Rule 10b-5 forbids more than just misrepresentations and omissions: "Commission Rule 10b-5 forbids, *among other things*, the making of 'any untrue statement of material fact' or the omission of any material fact 'necessary in order to make the statements made . . . not misleading.'" 17 CFR § 240.10b-5 (2004)." *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 340 (2005) (emphasis added).

Reading Rule 10b-5 as restrictively as Petitioners suggest, to include only misrepresentations and omissions, conflicts with this Court's interpretation of Section 10(b) and Rule 10b-5, and would eviscerate subparts (a) and (c). There is no justification for this interpretation. This Court should decline Petitioners' invitation to excise subparts (a) and (c) from Rule 10b-5 and deny the Petition.

Applying these principles, the Ninth Circuit considered whether the Complaint stated a claim under Section 10(b) based upon allegations of a scheme to defraud. *Homestore*, 452 F.3d at 1048; Pet. App. at 15a. Its opinion falls squarely within the language of Section 10(b) and this Court's precedent in holding that there can be liability for violation of Section 10(b) based upon a scheme to defraud, if all the other elements of Section 10(b) are satisfied. *Id.* at 1043; *see id.* at 1048; Pet. App. 3a; 15a-16a.

III. The Decisions Of Other Circuits Do Not Provide A Basis For This Court To Grant Certiorari In This Case

Petitioners seek review in this cased based upon their claim of a conflict with *Shapiro v. Cantor*, 123 F.3d 717 (2nd Cir 1977), *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215 (10th Cir. 1996), and *Ziemba v. Cascade Int'l., Inc.*, 256 F.3d 1194 (11th Cir. 2001). Because these cases all involved misrepresentations or omissions, which are considered under Rule 10b-5(b), none of these three Courts of Appeals had the occasion to discuss the distinction in the claims under different subparts of Rule 10b-5. *See Shapiro*, 123 F.3d at 719;[6] *Anixter*, 77 F.3d at 1226; *Ziemba*, 256 F.3d at 1203, 1206.

In contrast, the Ninth Circuit expressly noted that Rule 10b-5(b) concerns misstatements or omissions, while Rule 10b-5(a) and (c) concern fraudulent schemes. *Homestore*, 452 F.3d at

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6. Petitioners make much of the Second Circuit's statement that to be held primarily liable under Section 10(b), "a defendant must actually make a false or misleading statement." *Shapiro*, 123 F.3d 717, 720; Pet. at 13. However, the District Court in *In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472, 503 (S.D.N.Y. 2005), astutely noted that

> [t]he Second Circuit has made clear that to 'make' a statement for purposes of *Rule 10b-5(b)* requires that the statement must be attributed to its maker at the time it was made. That is a *different matter* from whether a defendant's challenged conduct in relation to a *fraudulent scheme* constitutes the use of deceptive device or contrivance.

(Emphasis added). Distinguishing between misstatements and deceptive devices in this way comports with this Court's decisions that recognize the distinction between claims under subparts (a) and (c) and claims under subpart (b) of Rule 10b-5. This analysis indicates that *Shapiro* is properly understood as limited in its applicability to Rule 10b-5(b). Accordingly, the decision below does not directly conflict with *Shapiro* because the decisions considered primary liability under different subparts of Rule 10b-5. *Anixter* and *Ziemba* are not in conflict with the Ninth Circuit for the same reason.

1046; Pet. App. 11a. The issue before the Ninth Circuit was "what conduct constitutes a manipulative or deceptive act in the furtherance of a scheme to defraud sufficient to render the defendant a 'primary violator' of § 10(b)?" *Id.* at 1048; Pet. App. 15a. Petitioners agree that the Ninth Circuit stated that it considered the sufficiency of the allegations regarding the use or employment of a deceptive device or contrivance by the Defendants, not liability based on actionable omissions or manipulation, because of the specific allegations in the Complaint. *Id.* at 1047 n.2; Pet. 13a. Thus, the decision below logically is focused on primary liability under subparts (a) and (c) of Rule 10b-5, which address primary liability for schemes to defraud.

Petitioners also assert that the decision below conflicts with the Eighth Circuit's decision in *In re Charter Communications, Inc. Sec. Litig.*, 443 F.3d 987 (8th Cir. 2006), *petition for cert. filed*, 75 U.S.L.W. 3034 (U.S. July 7, 2006) (No. 06-43). Pet. at 7. Yet, unmentioned by Petitioners is the fact that the Ninth Circuit specifically cited and followed *Charter*:

> Participation in a legitimate transaction, which does not have a deceptive purpose or effect, would not allow for a primary violation even if the defendant knew or intended that another party would manipulate the transaction to effectuate a fraud. See *In re Charter Commc'ns, Inc., Sec. Litig.*, 443 F.3d 987, 992 (8th Cir. 2006) (refusing to impose primary liability 'on a business that entered into an arm's length non-securities transaction with an entity that then used the transaction to publish false and misleading statements to its investors and analysts)[.]

Homestore, 452 F.3d at 1050; Pet. App. at 19a (bracketed material added).

In *Charter*, "Plaintiffs alleged that the Vendors entered into these sham transactions knowing that Charter intended to account for them improperly and that analysts would rely on the inflated revenues and operating cash flow in making stock recommendations." *Charter*, 443 F.3d at 991. The Eighth Circuit stated: "The Court can find no precedent for the conclusion that business partners, such as [the Vendors], made false and misleading statements by virtue of engaging in a business enterprise with a company such as Charter, the entity purported to have made the statement at issue." *Id.* at 991. The fact that the business partners may have known that the transactions would be used to mislead investors is insufficient to impose liability. *Id.* at 992-993.

Similarly in *Homestore*, the Ninth Circuit held that Respondent's allegations were insufficient to impose liability. As to AOL, the Ninth Circuit concluded:

> It is not alleged that AOL or its officers created sham business entities or engaged in deceptive conduct as part of illegitimate transactions, . . . There is no indication from the FACC that the transactions engaged in by AOL were completely illegitimate or in themselves created a false appearance . . . [I]t may not be liable for participating in legitimate transactions that became 'deceptive' only when distorted by the willful or intentional fraud of another party.

Homestore, 452 F.3d at 1052, 1053; Pet. App. at 25a, 26a (bracketed material added). For Cendant, the Ninth Circuit stated:

> We agree that the FACC [the Complaint] does not indicate how these transactions involving Cendant created a false appearance, independent from

> Homestore's misreporting of the income from these transactions as unrelated to any previous transaction . . . [T]he FACC does not allege that Cendant's specific actions in these transactions created a false appearance independent of the improper accounting by Homestore.

Id. at 1053, 1054; Pet.App. at 27a, 28a (bracketed material added).

Petitioners make much of supposed differences in the wording of these circuits' standards, but without showing that they differ in practical effect. Indeed, both the Eighth and Ninth Circuits found that business partners do not violate Section 10(b) for legitimate transactions that became deceptive only by the wilful misstatements of another party. *Charter*, 443 F.3d at 992; *Homestore*, 452 F.3d at 1050 (citing *Charter*, 443 F.3d at 992); Pet. App. 19a. Accordingly, if the Eighth and Ninth Circuits would reach the same conclusion regarding these allegations, the purported conflict is illusory and without practical effect.

In summary, review of the Ninth Circuit's decision based upon its alleged differences with other circuits is unwarranted, especially in light of the fact that Respondent currently has no case pending against Petitioners because its Complaint was dismissed and it was not allowed leave to amend to file an amended complaint against Petitioners.

IV. The Decision Below Properly Defined The Pleading Requirements For A Scheme To Defraud Under Section 10(b)

A. This Court Has Recognized The Distinction Between Claims Under Rule 10b-5(b) and Rule 10b-5(a) and (c)

This Court recognized the distinction between claims under Rule 10b-5(b) and Rule 10b-5(a) and (c) in *Affiliated Ute*, 406 U.S. at 128. Upon reviewing the Tenth Circuit's reading of Rule 10b-5 to require a misrepresentation (or omission), this Court concluded:

> [T]he Court of Appeals erred when it held that there was no violation of the Rule [10b-5] unless the record disclosed evidence of reliance on material fact misrepresentations by Gale and Haslem. We do not read Rule 10b-5 so restrictively. To be sure, the second subparagraph of the rule specifies the making of an untrue statement of a material fact and the omission to state a material fact. *The first and third subparagraphs are not so restricted.*

Id. at 152-153 (internal citations omitted; brackets and emphasis added). This Court therefore requires that a claim under Rule 10b-5(b) show a misrepresentation or omission, while a claim under 10b-5(a) or (c) need not.

The Southern District of New York's recent review of this Court's decisions reached the same conclusion regarding claims under Rule 10b-5(a) and (c):

> It is apparent from Rule 10b-5's language and the caselaw interpreting it that a cause of action exists under subsections (a) and (c) for behavior that constitutes participation in a fraudulent scheme, *even*

> *absent a fraudulent statement by the defendant.* See *Affiliated Ute*, 406 U.S. at 152-53; *SEC v. Zandford*, 535 U.S. at 820 ("Neither the SEC nor this Court has ever held that there must be a misrepresentation about the value of a particular security in order to run afoul of the Act.") . . . Claims for engaging in a fraudulent scheme and for making a fraudulent statement or omissions are thus distinct claims, with distinct elements.

In re Global Crossing, Ltd. Sec. Litig., 322 F. Supp. 2d 319, 335-336 (S.D.N.Y. 2004) (emphasis added).

Consistent with this Court's decisions, numerous district courts have applied the distinction in claims for violations of subpart (b) of Rule 10b-5 versus claims for violations of subparts (a) and (c). District courts in the Second Circuit (*e.g.*, *In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472, 491-492 (S.D.N.Y. 2005)); Third Circuit (*e.g.*, *In re PNC Fin. Servs. Group, Inc., Sec. Litig.*, 440 F. Supp. 2d 421, 434 (W.D. Pa. 2006)); Fourth Circuit (*e.g.*, *In re Ahold N.V. Sec. & ERISA Litig.*, 351 F. Supp. 2d 334, 372 (D. Md. 2004)); and Sixth Circuit (*e.g.*, *In re CMS Energy Sec. Litig*, 2005 U.S. Dist. LEXIS 439 at *20 (E.D. Mich. Jan. 7, 2005)) have recognized this distinction in claims for violations of subpart (b) of Rule 10b-5 versus claims for violations of subparts (a) and (c).

Similarly, district courts have recognized a "scheme to defraud" theory of liability similar to that of the decision below. *See In re Lernout & Hauspie Sec. Litig.*, 236 F. Supp. 2d 161, 172 (D. Mass. 2003) (denying a motion to dismiss brought by business partners who invented sham corporate entities that allowed a corporation "to hide research and development expenses, create fictitious revenue, and ultimately overstate profits in financial reports"); *In re Global Crossing, Ltd. Sec. Litig.*, 322 F. Supp. 2d 319, 336-337 (S.D.N.Y. 2004) (permitting

claims of primary liability to proceed where auditors "masterminded" the company's deceptive accounting practices). These district courts followed this Court's explicit recognition that the elements of claims under subparts (a) and (c) of Rule 10b-5, which concern fraudulent schemes, differ from the elements of claims under subpart (b).

B. The Decision Below Prohibits Primary Liability Under Section 10(b) For Aiding And Abetting a Scheme to Defraud

Petitioners' argument that the decision below imposes primary liability for aiding and abetting turns on agglomerating claims for misstatements and omissions and claims for fraudulent schemes. Petitioners' attempt to graft aiding and abetting liability into the decision below is unavailing for two reasons.

First, *Central Bank* acknowledges that indirect proscribed activity is distinguishable from aiding and abetting activity. *Central Bank* observed:

> The federal courts have not relied on the 'directly or indirectly' language when imposing aiding and abetting liability under § 10(b), and with good reason . . . The problem, of course, is that aiding and abetting liability extends beyond persons who engage, even indirectly, in a proscribed activity; aiding and abetting liability reaches persons who do not engage in the proscribed activities at all, but who give a degree of aid to those who do.

511 U.S. at 176. This statement indicates that indirectly using a "manipulative or deceptive device or contrivance" under Section 10(b), which involves engaging in prohibited conduct, has a different scope from aiding and abetting, which does not involve engaging in prohibited conduct. The statement also indicates

that an actor in a scheme to defraud can be a primary violator if that actor indirectly engages in manipulative or deceptive conduct.

According to the decision below, a secondary actor in a scheme to defraud can be primarily liable by directly or indirectly engaging in a deceptive act. *Homestore*, 452 F.3d at 1049; Pet. App. 17a to 18a. While asserting that the decision below permits aiding and abetting liability, Pet. at 18 to 20, Petitioners ignore that the decision below requires that "the defendant's *own conduct* contributing to the transaction or overall scheme must have had a deceptive purpose and effect." *Id.* at 1048; Pet. App. 16a (emphasis in original). The Ninth Circuit explains that "[u]nlike the scienter requirement, the 'purpose and effect' test is focused on *differentiating* conduct that may form the basis of a primary violation under § 10(b) from *mere aiding and abetting activity* that the Supreme Court has held does not constitute a primary violation." *Id.* at 1048 n.5; Pet. App. 17a (emphasis added). Aiding and abetting does not satisfy the Ninth Circuit or SEC test of primary liability. *Id.* at 1049; Pet. App. 18a.

Second, Section 10(b) and Rule 10b-5 both provide that "any person" may be held liable for violating the statute. This Court has stated that the "repeated use of the word 'any' in the statute and the rule is obviously meant to be inclusive." *Affiliated Ute*, 406 U.S. at 151. *Central Bank* recognized that "[s]ome of the express causes of action [in the 1933 and 1934 Securities Acts] specify categories of defendants who may be liable; others (like § 10(b)) state only that 'any person' who commits one of the prohibited acts may be held liable." 511 U.S. at 179 (bracketed material added; parentheses in original). Thus, the statute does not limit liability to specific types of actors, and the focus is not on who the actor is, but what the actor did.

C. The Decision Below Retains The Requirement Of Reliance

Petitioners contend that the decision below dispenses with the requirement of reliance. Not true. Following this Court's precedent, the Ninth Circuit concluded that the requirement of reliance is satisfied if a misrepresentation was introduced into the securities market as a result of the fraudulent scheme and defendant's conduct therein. *Homestore*, 452 F.3d at 1052. In reaching this conclusion, the decision below pointed to this Court's express endorsement of the fraud on the market presumption of reliance in *Basic v. Levinson*, 485 U.S. at 224. In *Basic*, this Court explained that the fraud on the market theory proposes that, in an open, developed and impersonal securities market, the price of a company's stock reflects the available material information on the company and its business. *Id.* at 241. Under the fraud on the market presumption, "[t]he causal connection between the defendants' fraud and the plaintiffs' purchase of stock in such a case is no less significant than in a case of direct reliance on misrepresentations," *id.* at 242, and "the reliance of individual plaintiffs on the integrity of the market *may be presumed*." *Id.* at 247 (emphasis added). As in *Basic*, the decision below concerned a fraud on the market where defendants' fraud did not involve direct misrepresentations.

Consistent with *Basic*, the decision below stated that the presumption is rebuttable in the absence of persuasive conflicting evidence. *Homestore*, 452 F.3d at 1052; *Basic*, 485 U.S. at 248 and 249 (defendants may rebut proof of the elements giving rise to the presumption). The decision below is therefore consistent with this Court's precedent regarding reliance.

D. The Decision Below Only Permits Liability For Conduct That Is Properly Viewed As "In Connection With" The Purchase Or Sale of Securities

Petitioners incorrectly claim that the decision below permits liability against secondary actors for conduct that cannot be seen as having occurred "in connection with" the purchase or sale of any security. Pet. at 23-26. Specifically, Petitioners argue that the decision below permits the "in connection with" requirement to be satisfied based solely on the later conduct of the issuer defendant. Pet. at 25.

The Ninth Circuit, however, stated that: "If multiple participants used or employed a deceptive device in furtherance of a scheme to misrepresent the reported revenues of a company, then all participants may be viewed as having acted in connection with the purchase or sale of securities." *Homestore*, 452 F.3d at 1051; Pet. App. 21a. Each defendant's conduct must be viewed alone to determine if it satisfied these requirements. *Id.* at 1050; Pet. App. 20a. Thus, the decision below comports with *Central Bank's* requirement that the conduct of each actor independently satisfy *each element* of a violation of Section 10(b). *Central Bank*, 511 U.S. at 191. The decision below does not involve "group" liability, but focuses on *each* defendant's conduct as part of the scheme to defraud, which scheme is consummated when the fraudulent information enters the securities market.

The Ninth Circuit properly cited to *Zandford*, 535 U.S. at 813 for the proposition that a scheme to misrepresent revenue may coincide with purchase or sale of a security because the scheme will not be complete until the fraudulent information is introduced into the securities market. *See* Pet. at 17 and 18. While characterizing *Zandford* as a Section 10(b) omission case involving a fiduciary, Petitioners fail to mention that *Zandford* described the alleged misconduct as intended to "further

respondent's fraudulent scheme," 535 U.S. at 820; "a fraud," *id.* at 821; and a "'course of business' that operated as a fraud or deceit . . . ," *id.* Following *Zandford*, where, as part of a scheme to misrepresent revenue, a defendant engages in a transaction whose principal purpose and effect is to create a false appearance of revenue, and where that effect continues at the time of purchases and sales of the company's stock, the fraud and the securities transactions in fact coincide. *See* SEC *Amicus Curiae* Reply Brief at 16 n.8. Because like *Zandford*, 535 U.S. at 822, the decision below requires that the scheme to defraud and the sale of securities coincide, it maintains the "in connection with" requirement for primary liability.

Moreover, the decision below is consistent with other courts, which have interpreted the "in connection with" requirement elaborated in *Bankers Life*, 404 U.S. at 12-13 to require "some nexus but not necessarily a direct and close relationship" between the fraud and the purchase or sale of a security. *Abrams v. Oppenheimer Gov't Sec., Inc.*, 737 F.2d 582 (7th Cir. 1984). The decision below is also consistent with *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 860 (2d Cir. 1968), *cert. denied sub nom., Coates v. SEC*, 394 U.S. 976 (1969), where the Second Circuit stated that the fraudulent device need not be employed at the same time as the sale of a security: "Congress when it used the phrase 'in connection with the purchase or sale of any security' intended only that the device employed, whatever it might be, be of a sort that would cause reasonable investors to rely thereon, and, in connection therewith, cause them to purchase or sell a corporation's securities." *Id.* at 860. Thus, because the "in connection with" requirement does not require that the scheme to defraud occur simultaneously with the sale of securities, the decision below properly maintains the "in connection with" requirement.

V. The Decision Below Promotes Predictability And Certainty

The Petition should be denied for two further reasons. First, the decision below promotes predictability and certainty because it is consistent with *Central Bank* and other precedents regarding primary liability. By applying the requirements for primary liability to subparts (a) and (c) of Rule 10b-5, the decision below promotes predictability and certainty with respect to primary violator liability under Section 10(b) and Rule 10b-5.

The decision of the Ninth Circuit does not create a "portal for plaintiffs to bring a species of 'aiding and abetting claims'" as Petitioners claim. Pet. at 27. The examples offered by Petitioners would all be held insufficient to bring a Section 10(b) claim by the Ninth Circuit and the four other Courts of Appeals relied upon by Petitioners (*e.g.*, a company enters into a transaction knowing that the other party will improperly account for it). Thus, any purported conflict is inconsequential, and the decision below promotes predictable and certain outcomes.

Second, the decision below imposes a high hurdle for pleading primary liability. Petitioners claim that it would permit Section 10(b)/Rule 10b-5 claims to proceed against any company "merely because they engaged in significant business transactions with issuers who allegedly accounted for the transactions fraudulently on their own books." Pet. at 29. Yet, such conduct would certainly not meet the test of the decision below. The plaintiff must plead with sufficient particularity that the company engaged in conduct with the principal purpose and effect of creating a false appearance of fact in furtherance of the scheme to defraud, and must meet all the elements of a Section 10(b) claim. The decision below makes clear that knowledge that the issuer would account for the transaction improperly *and* conduct that is consistent with the defendant's

normal course of business are *both* insufficient to state a claim under Section 10(b). *Homestore*, 452 F.3d at 1050; Pet. App. 19a.

After reviewing the allegations of the Complaint, the Ninth Circuit affirmed the District Court's dismissal because it found that the allegations were insufficient to show that Petitioners' and L90's conduct had the purpose and effect of creating a false appearance in fraudulent transactions that were part of a scheme to defraud. *Id.* at 1055; Pet. App. 28a.

In addition, to sufficiently state a primary violation, a plaintiff alleging a Section 10(b)/Rule 10b-5 violation in the Ninth Circuit must plead scienter with "particular facts giving rise to a strong inference of deliberate or conscious recklessness," *In re Silicon Graphics, Inc. Sec. Litig.*, 183 F.3d 970, 979 (9th Cir. 1999), an extremely stringent pleading standard. Considered together with the heightened pleading standards of Federal Rule of Civil Procedure Rule 9(b) and the Private Securities Litigation Reform Act of 1995, the decision below does not expand the scope of primary liability under Section 10(b).

CONCLUSION

For these reasons, the Petition for writ of certiorari should be denied.

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IN THE

Supreme Court of the United States

AVIS BUDGET GROUP, INC., FKA, CENDANT CORPORATION, TIME WARNER INC., RICHARD A. SMITH, DAVID COLBURN AND ERIC KELLER,

Petitioners,

v.

CALIFORNIA STATE TEACHERS RETIREMENT SYSTEM,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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STATEMENT PURSUANT TO RULE 29.6

The corporate disclosure statement of Petitioner Avis Budget Group, Inc., formerly known as Cendant Corporation ("Cendant"), was set forth on page ii of its Petition for a Writ of Certiorari ("Petition"), and there are no amendments to that statement.

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Respondent does not dispute that the question presented in the Petition involves an important and recurring issue of federal statutory law. Instead, Respondent focuses primarily on the underlying merits of the issues by arguing that the decision below comports with this Court's precedents. Petitioners[1] will not burden the Court with a repetition of how the decision below simply cannot be reconciled with this Court's precedents governing primary liability under Section 10(b) (*see* Petition at 14-18), a topic which is more appropriately addressed if certiorari is granted. Rather, this reply primarily addresses the two issues raised in opposition that more directly relate to whether certiorari is appropriate and warranted: (i) whether the issues raised by the Petition are now "moot" as a result of further proceedings that have occurred in the District Court, and (ii) whether there exists a real and deep conflict among the Circuit Courts warranting this Court's review.

I. *The Issues Presented in the Petition Are Not Moot*

In the decision below, the Ninth Circuit remanded this matter to the District Court to allow Respondent the opportunity to seek leave to amend its complaint in a manner which might satisfy the Ninth Circuit's newly-articulated standards for "scheme" liability against secondary actors such as Petitioners. On remand, the District Court entered an order on December 18, 2006 denying Respondent's motion for leave to amend as against Petitioners, concluding that amendment would be futile because the proposed second amended complaint ("SAC") failed to allege any facts that could establish primary Section 10(b) liability under the Purpose and Effects Test[2] adopted by the Ninth Circuit in

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[1] Time Warner Inc., David Colburn, and Eric Keller are no longer petitioners because they reached a settlement with Respondent after the Petition was filed.

[2] Capitalized terms herein not otherwise defined have the meanings ascribed to them in the Petition.

the decision below ("Order on Remand"). Respondent filed a Notice of Appeal from the Order on Remand in the Ninth Circuit on January 18, 2007.

According to Respondent, the Petition is now "moot" because Petitioners — by virtue of the Order on Remand — are not parties to the action and have no "legal interest" in this Court's review of the issues raised in the Petition. (*See* Resp. Br. at 11). As both a matter of logic and law, however, Respondent is wrong.

A case becomes "moot" only when "'the issues presented are no longer 'live' or the parties lack a legally cognizable interest in the outcome.'" *City of Erie v. Pap's A.M.*, 529 U.S. 277, 287 (2000) (citation omitted). Put differently, a case becomes moot when "an event occurs while a case is pending on appeal that makes it *impossible* for the court to grant 'any effectual relief whatever' to a prevailing party." *Church of Scientology of California v. United States*, 506 U.S. 9, 12 (1992) (quoting *Mills v. Green*, 159 U.S. 651, 653 (1895)) (emphasis added).

Here, Respondent has appealed from the Order on Remand, in which the District Court concluded that the SAC failed to allege facts that could establish primary Section 10(b) liability against Petitioners under the very standards for "scheme" liability that are at issue in the Petition, and which the Ninth Circuit articulated for the first time in the decision below. Thus, in order to resolve Respondent's appeal, the Ninth Circuit will again apply these new legal standards, which Petitioners submit are inconsistent with this Court's precedent and in conflict with the approach of *four* other Circuit Courts. As with any appeal, there is a possibility that the Ninth Circuit could reverse the District Court's findings, and conclude that the SAC *does* state a claim against Petitioners under the legally-defective standards for liability

established below. Against this backdrop, it simply is inaccurate, as Respondent contends, that the issues raised by the Petition are no longer "live" or that Petitioners lack any "legal interest" in this Court granting certiorari.

It also is quite clear that this Court could grant "effectual relief" to Petitioners were it to grant certiorari. In *In re Charter Communications, Inc. Securities Litigation*, 443 F.3d 987 (8th Cir. 2006), *petition for cert. pending*, (No. 06-43), which directly conflicts with the decision below (*see* Petition at 11-13 & Point II, below), the Eighth Circuit correctly applied *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), and held that "any defendant who does not make or affirmatively cause to be made a fraudulent misstatement or omission, or who does not directly engage in manipulative securities trading practices, is at most guilty of aiding and abetting and cannot be held liable under Section 10(b) or any subpart of Rule 10b-5." *Charter*, 443 F.3d at 992. Here, Petitioners were not alleged to have made, or to have participated in the making of, any of the false and misleading statements or omissions challenged in the litigation below (or to have engaged in any act of "manipulation"). Therefore, under the Eighth Circuit's holding in *Charter*, Petitioners could not be primarily liable under Section 10(b) as a matter of law.

The litigation and pending appeal against Petitioners would necessarily be decided finally in their favor if this Court were to grant certiorari and conclude that the Eighth Circuit's approach to "scheme" liability is correct. Because a grant of certiorari can result in such effectual relief, the issues raised by the Petition are by no means "moot."

II. *There is a Real and Deep Circuit Conflict Meriting This Court's Review*

Respondent also contends that there is no "practical" conflict between the decision below and *Charter*, and that the decision below also does not conflict with any other Circuit's approach. As demonstrated in the Petition, however, the conflict between the decision below and *Charter* — as well as every other Circuit Court that has considered the circumstances under which secondary actors may be primarily liable under Section 10(b) in the wake of *Central Bank* — could not be any more direct. (*See* Petition at 11-14).

Indeed, the plaintiffs in *Charter* pursued precisely the same "scheme" theory of liability Respondent has pursued here, and sought to hold non-speaking secondary actors primarily liable under Section 10(b) for allegedly entering into "sham transactions" with the issuer "knowing" that the issuer intended to later account for them improperly. *See Charter*, 443 F.3d at 989-990. The Eighth Circuit squarely rejected plaintiffs' Rule 10b-5 "scheme" theory of liability as an attempt to circumvent *Central Bank* and held that "any defendant who does not make or affirmatively cause to be made a fraudulent misstatement or omission, or who does not directly engage in manipulative securities trading practices, is at most guilty of aiding and abetting and cannot be held liable under Section 10(b) *or any subpart* of Rule 10b-5." *Id.* at 992 (emphasis added).

In direct contrast, the Ninth Circuit held below that a secondary actor may be primarily liable under Section 10(b) for engaging in a "scheme to defraud" consistent with *Central Bank*, even if it did not make any of the challenged misstatements or omissions, so long as it engaged in conduct

that satisfies the newly-articulated Purpose and Effects Test.[3] Thus, pursuant to the standards articulated by the Ninth Circuit, secondary actors can be primarily liable for securities fraud under a "scheme" theory of liability for engaging in conduct *short of actually making a misstatement or omission.* Accordingly, it is difficult — if not impossible — to understand how this decision is *not* in conflict with *Charter*, in which the Eighth Circuit expressly and unequivocally held that a secondary actor must actually make a misstatement or omission to be liable under Section 10(b), and that anything less is nothing more than "aiding and abetting."[4]

---

[3] According to the decision below, as well as *Charter*, a secondary actor could also be primarily liable for engaging in an act of "manipulation," as that term of art has been defined by this Court. However, there was no contention in *Charter*, or here, that the secondary-actor defendants engaged in any such conduct.

[4] No doubt in light of this obvious and direct conflict, Respondent also argues that, despite differing legal "standards," the Eighth and Ninth Circuits approaches do not matter in "practical effect." (*See* Resp. Br. at 21). Respondent is mistaken. In holding that Respondent's allegations failed to satisfy the Purpose and Effects Test, the Ninth Circuit reasoned below, *inter alia*, that Respondent did not adequately allege that the transactions at issue were "sham" or "illegitimate" transactions from the time that they were entered into. *See* Pet. App. at 26a-28a (petitioners "may not be held liable for participating in *legitimate* transactions that became 'deceptive' only when distorted by the willful or intentional fraud of another party.") (emphasis added)). In contrast, in *Charter*, the plaintiffs had alleged that the transactions entered into by the secondary actors were in fact "sham" transactions from the beginning, and yet the Eighth Circuit held, as a matter of law, that such actors could not, in any event, be held primarily liable under Section 10(b) because they were not alleged to have made any of the challenged misstatements or omissions. *See Charter*, 443 F.3d at 992. Thus, the decisions conflict as a matter of "practical effect," because entering into a business transaction perceived as "illegitimate" could result in liability for a non-speaking secondary actor under the Ninth Circuit's Purpose and Effects Test, but could at most be "aiding and abetting" under the Eighth Circuit's approach in *Charter*.

Moreover, as established in the Petition, the Ninth Circuit's newly-articulated standards for "scheme" liability also conflict with three other Circuit Courts which have held that, in light of *Central Bank*, a secondary actor cannot be primarily liable under Section 10(b) if it did not actually make any of the challenged misstatements or omissions or engage in any acts of manipulation. *See, e.g.*, *Shapiro v. Cantor*, 123 F.3d 717, 720 (2d Cir. 1997) ("'If *Central Bank* is to have any real meaning, a defendant must actually make a false or misleading statement . . . [a]nything short of such conduct is merely aiding and abetting . . . .'") (citation omitted); *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215, 1226 (10th Cir. 1996) (same); *Ziemba v. Cascade Int'l, Inc.*, 256 F.3d 1194, 1205 (11th Cir. 2001) (same). (*See also* Petition at 13-14).

According to Respondent, these decisions are not truly in conflict with the decision below because they addressed subsection (b) of Rule 10b-5, whereas "scheme" liability implicates subsections (a) & (c) of Rule 10b-5. (*See* Resp. Br. at 18). But contrary to Respondent's assertion, these Circuit Court holdings are not limited to Rule 10b-5(b); rather, they clearly resolve the broader question of the scope of liability for secondary actors under Section 10(b) itself. *See, e.g.*, *Shapiro*, 123 F.3d at 720 ("'a defendant must actually make a false or misleading statement in order to be held liable under *Section 10(b)*'") (citation omitted) (emphasis added)); *accord Anixter*, 77 F.3d at 1226; *Ziemba*, 256 F.3d at 1205. Respondent's purported "distinction" also is irrelevant in light of this Court's repeated recognition that subsections (a) and (c) of Rule 10b-5 cannot create liability for conduct that is not prohibited under Section 10(b), the Rule's enabling statute. (*See* Petition at 15 (citing cases)).

Finally, despite the Circuit conflict and continuing debate over whether, consistent with precedents of this Court,

secondary actors can be liable for engaging in a "scheme to defraud" without making a misstatement or omission, Respondent contends that review of the decision below is not warranted in any event because it imposes a "high hurdle" for "scheme" liability against secondary actors. (*See* Resp. Br. at 29). In this regard, Respondent relies primarily on the fact that leave to amend was denied as against Petitioners in the Order on Remand. The result reached in the Order on Remand, however, in no way undermines the compelling reasons why this Court should grant certiorari and resolve the Circuit conflict now.

To begin with, in the Order on Remand, leave to amend was in fact *granted* as to L-90, a secondary actor defendant below that is not a party to the Petition, which demonstrates that the standards articulated in the decision below are not insurmountable, as a matter of pleading, as Respondent would have this Court believe. More fundamentally, the mere fact that a secondary actor may *ultimately* prevail (on the merits or otherwise) in any given "scheme" case on the merits or otherwise, does not alter the practical reality that the decision below creates a portal for plaintiffs to bring and pursue, as Respondent has, a species of "aiding and abetting" claims against secondary actors that is at odds with Section 10(b) and *Central Bank*. Indeed, the mere existence of the Ninth Circuit's opinion has encouraged and will continue to authorize lower courts to allow these types of actions to survive the pleadings stage. *See, e.g.*, *Steiner v. MedQuist Inc.*, No. 04-5487, 2006 U.S. Dist. LEXIS 71952 (D.N.J. Sept. 29, 2006) (court relied on the Ninth Circuit's Purpose and Effects Test in denying motion to dismiss Section 10(b) claims based on a "scheme" theory of liability against individual defendants who were not alleged to have made any of the challenged misstatements or omissions). *See also In re Enron Corp. Securities Derivative & "ERISA" Litig.*, No. H-01-3624, 2006 U.S. Dist. LEXIS 43146, at *157-74 (S.D. Tex. June 7, 2006) (court rejected the District Court's

decision in *Homestore* (*see* Pet. App. at 32a-90a) and the Eighth Circuit's holding in *Charter* in finding that plaintiffs adequately alleged a "scheme" theory of liability under Section 10(b) against defendants who were not alleged to have made any of the challenged misstatements or omissions); Petition at 26-28 (citing cases denying motions to dismiss and allowing plaintiffs to proceed on "scheme" theories of liability). Particularly in the context of securities litigation, this risk of excessive, vexatious litigation alone warrants review of the decision below, even if a secondary actor might at some point prevail (no doubt after having to expend a significant amount of time and money) in actions filed as a result of the legally-defective standards articulated by the Ninth Circuit. *See e.g.*, *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 126 S. Ct. 1503, 1510-11 (2006) (discussing "the widespread recognition that 'litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general'") (citation omitted). (*See also* Petition at 28 (citing cases)).

CONCLUSION

The petition for a writ of *certiorari* should be granted.

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